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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1984

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-EIGHTH CONGRESS

SECOND SESSION

ON

OVERSIGHT ON THE MONETARY POLICY REPORT TO CONGRESS PURSUANT TO THE FULL EMPLOYMENT AND BALANCED GROWTH ACT OF 1978

JULY 25 AND 31, 1984

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1984

WEDNESDAY, JULY 25, 1984

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9:30 a.m., in room SDG–50, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Gorton, Mattingly, Hecht, Proxmire, Riegle, Sasser, and Lautenberg.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The Banking Committee will come to order.

Mr. Chairman, we are happy to have you with us for your semiannual report to the Senate Banking Committee. It appears for the first time we have a room big enough to handle everyone. As a matter of fact, there are empty seats, but I do think this is more comfortable for everybody than our normal hearing room.

Although we are happy to have you before the committee today, I wish I could say I was happy to be back in Washington, but as I was just saying to my colleagues, it's the best recess that I have ever had. We should have Presidential elections every year so the Congress can get out of town. I can hardly wait until the Republicans have theirs so we can leave again. It's a delightful time in Utah and the world still has both feet on the ground out there with none of the panic we see in Washington.

In any event, I have been very pleased during the recess to see from the economic indicators that the economy is still continuing to grow and progress. So we are happy to have you before the committee again.

Senator Proxmire, do you have a statement you wish to make?

OPENING STATEMENT OF SENATOR PROXMIRE

Senator Proxmire. Thank you, Mr. Chairman.

Chairman Volcker, as the chairman of this committee has indicated, the economic news could hardly be better. Here we have the biggest increase in jobs in America's history in the last 1½ years, 6 million. We have inflation behaving like a perfectly trained hunting dog, staying below 4 percent. We have exuberant economic growth, 9.5 percent in the first quarter of the year and 7.5 percent in the second quarter. Personal income is breaking all records.

Just this morning, the New York Times reported that auto sales in mid-July broke a 6-year record for that period. We are beginning to move into the classic framework for inflation to break out of its remarkably gentlemanly like behavior. We are operating at well above 80 percent of capacity. While overall unemployment is still at 7 percent, it's below 4 percent in Massachusetts, below 5 percent in a number of States. As we all know, unemployment is a lagging indicator so we can expect it to fall for another 6 months or more. This means labor shortages that will certainly tend to push up wages and prices.

All this can be expected a few months into 1985, but not before the election, of course. Our current account balance is at an annual rate of minus $70 billion. The deficit account is at an annual rate of $170 billion and the Nation's investors are so concerned that they shoved the stock market down yesterday to the lowest level in 1½ years, in spite of all the great economic news.

It would be hard for this Senator to imagine a scenario that would more emphatically call out for monetary restraint.

Now contrast this with the last Presidential election year, 1980. For the first half of 1980, economic growth actually declined at an annual rate of more than 3 percent compared to this year's exuberant growth. Unemployment was higher than it is now and rising and the price level was substantially higher than it is today but it was falling. Our current account balance for the first half of 1980 was bobbing along not at $70 billion but at an annual rate of minus $5 billion on its way to actual favorable balance plus for the year; and the deficit in the first half of 1980 was moving at an annual rate of $50 billion, less than a third of the present level.

By and large, the 1980 economic situation seemed to have called for a much easier monetary policy than the present 1984 economic situation.

Now I know you don't think in political terms and you shouldn't, but the big fact is that this is an election year and I hope you will treat President Ronald Reagan with the same objective, arm's length election year fairness, with the same meticulous disregard for political consequences that you treated President Carter.

When Vince Lombardi was coach of the Green Bay Packers a reporter asked one of the players whether Lombardi showed any unfairness in the treatment of players. The player told the reporter, "Listen, Coach Lombardi treats us all the same—like dogs."

Mr. Chairman, I hope you can show that same objectivity and painstaking fairness in dealing with the Presidential candidates in the 3 months before the election.

The CHAIRMAN. Senator Mattingly.

Senator MATTINGLY. I have no statement at this time.

The CHAIRMAN. Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Mr. Chairman, I will make just one brief comment because I am interested to hear what Chairman Volcker has to say to us today. I, too, am concerned with the structural problems that Senator Proxmire touched upon and what is obviously a very substantial apprehension in the financial markets over the contradictions that are out there—on the one hand the strong economic growth, while on the other hand we have rising interest rates, and greater and greater pressure on financial institutions. The bailout of Continental Illinois graphically illustrates this pressure, but we also have another 700 banks in trouble and the savings and loan industry increasingly in trouble. Other problem areas include the trade deficit, as was just noted, and the selloff that's occurring in the stock market which seems to reflect the financial markets' view and apprehensions about the future. I would hope that as you go through your statement you will elaborate on areas that deal with the structural strengths of the system to handle the problems that it now faces.

Thank you, Mr. Chairman.

The **Chairman**. Senator Hecht.

Senator **Hecht**. I have no statement, Mr. Chairman.

The **Chairman**. Senator Heinz.

Senator **Heinz**. No statement.

The **Chairman**. Mr. Chairman, please proceed.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. **Volcker**. Thank you, Mr. Chairman and Senators. I think I will touch upon matters that you raised in your opening comments except for the delights of being in Salt Lake City, but you do have some work to do here.

[The complete statement and the midyear monetary policy report to Congress follow:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

I appreciate the opportunity to appear once again before this Committee to review monetary policy in the context of our overall economic performance and problems. In accordance with the Humphrey-Hawkins Act, the semi-annual report of the Federal Reserve Board reviewing economic developments and the decisions of the Federal Open Market Committee with respect to monetary and credit targets for 1984 and 1985 was transmitted to you this morning. As indicated there, the FOMC reaffirmed the target and monitoring ranges for the various monetary and credit aggregates for 1984 and decided to reduce the top end of the ranges for M1 and M2 for 1985. I will discuss that later in my testimony. First, I would like to summarize some key points about the economy and call your attention to particular problems that present clear risks to an otherwise positive outlook.

The Overall Economic Performance

Measures of aggregate economic activity, employment, costs, and prices have provided an almost unbroken string of favorable news so far in 1984. The process of recovery from the deep and prolonged recession -- a recovery that began amid widespread doubts about both its potential vigor and staying power -- had proceeded strongly through 1983. There were widespread anticipations early this year that, as we moved beyond recovery into a new expansion phase, the pace of growth would slow. But in fact growth actually accelerated as we moved into this year. During the second quarter of 1984, the economy as a whole operated at a level more than four percent higher than in the closing months of last year and 7-1/2 percent higher than a year earlier.

Almost three million more people have been employed so far this year, bringing the total gains over the past 18 months close to 7 million. The unemployment rate has dropped to about 7 percent. Business investment has risen very rapidly this year, while consumer spending has remained strong. The forward momentum of the economy still appears considerable.

At the same time, inflationary pressures have to this point remained subdued, with most summary price measures rising little, if at all, faster than the sharply reduced rate of 1983. In fact, a number of sensitive commodity prices have dropped recently, following sizable cyclical increases. Highly competitive domestic and international markets, influenced by the strength of the dollar overseas and continued strong efforts to discipline costs, have been key factors contributing to greater price stability. The net result has been rising productivity and good gains in real incomes, even while nominal wage and salary increases have remained moderate.

Looking only at these overall measures, this recovery and expansion period has been atypical -- atypical in the sense that such a rapid expansion has been maintained longer after the recession trough than in any comparable cyclical period since World War II, excepting only the Korean War episode. But the period has been atypical in other ways as well -- in ways that potentially could have severely adverse implications unless dealt with by timely and effective policy actions.

Imbalances and Strains

In any period of recovery and expansion, some sectors fare relatively better or worse than others, and in that general respect this period has been no exception. Some of our heavy industries -- for instance, steel and other metals and heavy machinery -- are still at operating rates well below earlier experience. Demand for our agricultural products from abroad has not been buoyant, and many farmers -- particularly those with large debts -- are being severely squeezed by high interest rates and falling land prices.

What is different, in degree and in kind, is that some inevitable unevenness in patterns of growth in particular sectors has been aggravated by the massive and related imbalances in both our fiscal position and our international trading accounts and by some strains in financial markets. As you know, rapid growth has been reflected in some reduction in the budgetary deficit, estimated for fiscal 1984 in the neighborhood of $170-$175 billion. The Congress is in the process of enacting the so-called "downpayment" against future deficits, part of which has already been signed by the President. But the hard fact is, as I am sure the Congress is fully aware, the deficit remains huge in absolute and relative terms, and absent further action little or no further decline now seems probable for 1985 and beyond, even assuming the economy continues to move to "full employment" levels.

That circumstance has been reflected in continued large Treasury borrowings, and expectations of indefinite continuation.

Meanwhile, private credit demands, responding to and supporting growth in consumption and investment, have accelerated. Personal savings relative to income have remained in the lower range characteristic of the late 1970s, and despite growth in internally generated corporate cash flows, the sources of domestic funds have fallen far below our demands. In these circumstances, interest rates -- already historically high -- tended to move still higher during the spring. Those high interest rates, combined with favorable economic conditions generally in this country, have attracted more and more capital from abroad to help meet our domestic needs, and the dollar has appreciated despite deterioration in our trade and current accounts.

The strong dollar and the ample availability of goods from abroad at a time when growth in most other developed countries has been relatively sluggish have certainly been potent forces helping to contain inflation. The capital inflow, supplementing our net domestic savings by a quarter, has been a factor containing pressures on our own financial markets. And, the large rise in our imports has helped stimulate economic activity among some of our leading trading partners and eased somewhat the severe adjustment process underway in Latin America.

But what is in question is the sustainability of that process, as the United States becomes more and more dependent on foreign capital, as our export and importing-competing industries are damaged and seek protectionist relief, and as interest rate pressures remain strong. The only real question is whether the needed and inevitable adjustments will be facilitated and encouraged by constructive public policies, consistent with long-term growth and stability, or whether we are content, despite all the strains and dangers, to let events simply take their course. Short-sighted relapses into lack of financial discipline, widespread protectionism, and wage and pricing excesses could only aggravate the situation.

It is, in the end, the choice between building on the enormous progress of the past to achieve sustained growth in a framework of greater stability or a relapse into inflationary economic malaise. With that choice clear, I am confident that the needed policies are well within our collective grasp.

The continuing difficulties of some heavily indebted developing countries in Latin America, and in some other places as well, has been one point of uncertainty. A sense of greater concern has, ironically, come at a time when several of the largest borrowers have more clearly made substantial progress toward reducing external financing requirements and toward carrying out the more fundamental adjustments that should provide a firm base for their renewed growth. But other borrowing nations have made less progress, and the uncertainties have been fed by signs of growing protectionism in industrialized countries and by the increases in interest rates in the United States which impact directly on debt service costs of countries with large external dollar-denominated debt.

Within the United States, the relatively high level of interest rates has aggravated financial pressures in the farm sector. Many thrift institutions face the prospect of weak earnings at a time when capital positions have been eroded by losses earlier in the decade. And, despite the rapid growth of the economy and strong increases in business profitability overall, more stable prices have exposed some weaknesses in credit practices in the energy and other areas encouraged by earlier inflationary expectations.

Monetary Policy

These developments have provided the setting for the implementation of monetary policy thus far in 1984 and for the review of monetary and credit objectives by the Federal Open Market Committee for this year and next.

In reaching its policy judgments, the Committee members shared the widespread view that the overall rate of economic growth would moderate soon as resources become more fully employed and would continue through 1985 at a sustainable pace. While the rate of price increase has been somewhat slower than expected over the first half of 1984, that rate is generally expected to rise by a percentage point or so next year, assuming that the dollar remains in the same general range as over the past year. In making those projections, which are detailed in Table I attached, Committee members also noted that continued high budget deficits and other factors, unless dealt with effectively, would pose substantial risks of less satisfactory results with respect to economic activity or prices or both.

The economic projections, of course, took account of the decisions made on monetary policy. Broadly, monetary policy will remain directed toward providing enough money to support sustainable growth while continuing to encourage greater price stability over time. As detailed in the full report, Committee members felt that broad objective was consistent with the growth ranges for money and credit specified in February for this year, and no changes were made. For 1985, the tentative decision was reached to reduce the ranges slightly for both M1 and M2, specifically by lowering the top end of the ranges specified for this year by 1% and 1/2%, respectively. The target range for M3 and the monitoring range for domestic credit were left unchanged. These tentative decisions for 1985, reflected in Table II attached, will be carefully reviewed at the start of next year.

In assessing the appropriate ranges, and the relative weight to be placed upon the various aggregates, the Committee reviewed the evidence of more typical cyclical behavior of M1 in recent quarters relative to GNP, following the unusual behavior of velocity in 1982 and early 1983. In the light of that examination, it felt that roughly equal weight should be given each of the monetary aggregates in implementing policy. However, appraisals of their movements, and relationships among them, will continue to be judged in the light of developments in economic activity, inflationary pressures, financial market conditions, and the rate of credit growth.

While both M1 and M2 have grown within their targeted ranges of this year, 4 to 8 percent and 6 to 9 percent respectively, M3 and particularly domestic credit, have expanded faster than anticipated. Credit growth has, in fact, continued to outpace that of nominal GNP, as was the case last year but contrary to longer-term trends. Viewed in a medium-term or longer perspective, those growth rates for M3 and domestic credit are higher than consistent with sustainable rates of growth in the economy and progress toward price stability. For that reason, the Committee decided not to raise the target ranges for this year, feeling that would provide an inappropriate benchmark for measuring desired long-run growth, even though Committee members recognized that, as a practical matter, growth in these aggregates, at least for domestic credit, would likely exceed the specified ranges.

In reaching those judgments, the Committee recognized that the rate of business credit growth had been amplified by an unusual spate of merger activity and corporate financial reorganizations -- so-called "leveraged buy-outs" -- that had the effect of substituting debt for equity. The implications of those financings, while potentially adverse from the standpoint of the overall financial strength of particular businesses, are relatively neutral from the standpoint of demands on real resources and overall credit market conditions. Estimated adjustments for that activity on the rate of overall credit growth would reduce the indicated expansion over the first half of the year from a rate of about 13 percent to 12 percent, closer to, but still above, the monitoring range. That growth, together with the extraordinary rise in consumer and Federal Government debt, is shown in Table III.

Typically, Federal deficits shrink substantially as the economy moves into the second and third years of expansion -- there was a day when balance or surplus was the reasonable objective. That is not happening this time. And in contrast to 1982 and most of 1983, Treasury must compete strongly with accelerated demands for consumer and business credit and a continued high level of mortgage borrowing.

With long-term markets unreceptive, much of the increase in business and consumer borrowing is being done at banks. Thrift institutions remain highly active in the mortgage markets. These institutions, in turn, rely increasingly on certificates of deposit and other forms of market finance included in the M3 aggregate, accounting for its relative strength.

In implementing the policies reflected in the various targets, steps were taken during the late winter and early spring to increase somewhat pressures on bank reserve positions, and the discount rate was raised once, from 8-1/2 to 9%. Reserve pressures have not changed appreciably since that time, as reflected in relatively unchanged borrowings at the discount window (apart from those by the troubled Continental Illinois Bank). With both M1 and M2 remaining within their target ranges, and against the background of the economic, price, and financial market developments reviewed earlier, stronger restraining actions on money and credit growth generally have not appeared appropriate. At the same time, the relatively rapid rates of growth in M3 and domestic credit are flashing cautionary signals.

While pressures on bank reserves did not increase further, both long- and short-term interest rates rose over the spring. The continued heavy credit demands, expectations that those demands would persist against the background of the huge federal deficit and strong economic expansion, and fears of a resurgence of inflationary pressures as both labor and capital are more fully employed all played a part. In more recent weeks, rates have tended to stabilize at high levels, perhaps partly because current price trends have, at least so far, not borne out more extreme inflationary concerns expressed earlier. Nonetheless, markets remain volatile and apprehensive.

International and Domestic Banking Markets

The atmosphere surrounding credit and banking markets at times during recent months has been appreciably influenced by the apparent difficulties of one of the nation's largest banks and by continuing concerns over the ability of some developing countries tc service debts held mainly by large commercial banks around the world.

As I have reported to the Committee before, orderly and full resolution of the latter problem will require a strong cooperative effort by borrowers and lenders alike over a considerable period of time. A few minutes ago, I noted there are, in fact, encouraging signs that the difficult process of internal and external adjustment is beginning to bear fruit in important countries in Latin America, including Mexico, Venezuela and Brazil. Negotiations are currently underway by the first two of those countries with banks looking toward a long-term restructuring of their external debt at terms reflecting the evidence of prudent policies and improving credit-worthiness. Provided that growth is maintained in the industrialized countries and markets for their products are not closed, prospects for economic recovery and growth on a sustainable basis in those Latin American countries appear more favorable, helped to a substantial extent by the growth in our own markets. In other countries the adjustment process is less advanced, but the progress of some, both in adjustment and financing, can point the way for others. While the challenge for all remains substantial, we need to view it realistically, as a situation that justifies neither neglect nor despair. Rather, appropriate approaches tailored to the needs of each country can bring results. But with that effort on all sides, the problem is manageable.

The problems of Continental Bank essentially reflected serious weaknesses in the domestic loan portfolio of a bank that had engaged in aggressive growth and lending practices for some time, including heavy involvement in participations in energy loans of the Penn Square Bank that failed two years ago. As other credit losses surfaced and earnings pressures continued, market sources of funding were reduced and the bank became heavily dependent on discount window borrowings during the spring. As the atmosphere surrounding the bank deteriorated and threatened to disturb markets more generally, the supervisory authorities, together with a group of other major banks, provided a massive financial assistance program pending a more permanent solution. I believe those more lasting arrangements will be announced shortly, and will provide a firm base for a healthy, but considerably smaller bank.

That situation is unique for a large bank, but the episode may be an object lesson about the importance of looking ahead to anticipate problems.

In a period of rapid economic and credit expansion, there can be temptations to relax prudent credit standards in an effort to maximize growth. With deposit markets deregulated, there may be a perception by individual banks that added funds can be raised as needed in domestic or foreign markets by bidding rates higher to fund larger and larger loan portfolios -- and that loan rates can be raised as fast as deposit rates. But the aggregate supply of funds is ultimately not really inexhaustible; confidence must be maintained, and high and volatile interest rates can undermine the credit-worthiness of weaker borrowers.

When external economic developments and high interest rates impair the ability of otherwise credit-worthy borrowers fully to maintain scheduled debt service on loans made earlier in a different economic environment, prudent banking may indeed suggest forebearance and renegotiation of outstanding loans. We, for instance, have introduced supervisory procedures to assure that examiners refrain from criticizing banks for exercising forebearance on agricultural credits when consistent with safety and soundness. I also believe that, when heavily indebted countries are moving aggressively to improve their credit-worthiness, restructuring of foreign credits over a substantial period, and the provision of new money as part of an appropriate adjustment program under IMF auspices, may be indispensable parts of a favorable resolution of the international debt problem over time.

But clearly the need remains to anticipate new problems, as well as to deal with old ones. Recent credit-financed mergers have attracted a great deal of attention, and some of those have involved very large and strong companies. But there is a disturbing element in some mergers and in leveraged buy-out activity viewed more generally; it reduces appreciably the equity cushions of the resulting company.

For the economy as a whole, equity in U.S. corporations (apart from retained earnings) was retired at an annual rate of some $75 billion over the first half of 1984. That seems anomalous at a time of rising business activity and profits, and when stronger corporate balance sheet ratios would be welcome. In evaluating prospective loans to support mergers or leveraged buy-outs, bank managers need to appraise the risks prudently, taking full account of the possibility of a more adverse economic and interest rate environment. That, of course, is and should be customary policy of banks, and I sense some have reviewed practices in that respect to make sure they are appropriate in today's circumstances.

Asset growth in any event needs to be supported by adequate risk capital, and I am glad to report that capital positions of the largest banks and their holding companies have generally improved over the past few years from the relatively low levels reached during the 1970s. The supervisory agencies are in the process of developing guidelines for further improvement for those banks and holding companies, and specific proposals are now being tested against public comment. The approaches we are adopting are, I believe, fully consistent with the intent of the International Lending Supervision Act sponsored by this Committee last year and, so far as holding companies are concerned, with the spirit of the provisions touching upon capital in S. 2851.

In that connection, I would also emphasize that capital adequacy and asset strength are only two of several important tests of the strength of a banking organization. Maintaining an adequate liquidity cushion and opportunities for maintaining and improving earnings without undue risk are also of critical importance.

Conclusion

Indicators of overall economic performance have been exceptionally favorable for more than a year. So far, a strong economic expansion has been consistent with better price performance than we have enjoyed for many years.

At the same time, there are obvious strains, imbalances, and risks that, unless dealt with forcefully, could undercut much of what has been achieved. High interest rates are plainly a symptom of the excessive demands on our savings as well as lingering (and related) concerns about inflation. Certainly, there is no evidence, in the midst of rapid economic expansion, high rates of growth in debt, and the monetary trends I have described, that the economy has been starved for money and credit. Indeed, the challenge over time will remain to work toward growth of money and credit consistent with lasting price stability. And we need to do that in ways that relieve heavy pressures on vulnerable sectors of the economy, make us less dependent on foreign capital, and reduce strains on the international financial system.

None of these problems will be cured by attempts to drive interest rates down artificially by excessive money creation; the inflationary repercussions could only aggravate the situation. Nor can distortions arising from other sources be dealt with effectively by any general monetary measures.

But we are, as a country, by no means helpless in dealing with the strains and risks.

With respect to the budget deficits, as things now stand, deficits next year will remain in the same area as currently, and unacceptably large thereafter. The implications for financial markets and the economy become more adverse precisely as growth in the private sector generates more need for credit and capital. That outlook must be changed in the only way it constructively can be -- moving beyond the welcome "down payment" to further substantive action on the budget as soon as feasible.

With respect to our exceedingly large trade deficit, protectionist pressures are understandable, but it is no less important to avoid measures -- all too likely to be emulated abroad --

that would drive up costs, undermine the fabric of trade, and place new barriers in the place of heavily burdened debtors already struggling to make necessary adjustments. And industry and labor must continue to be sensitive to the need to remain competitive in their own wage and price decisions.

With respect to our financial fabric, public policy needs, at one and the same time, to respond strongly to threats as they emerge, while undertaking supervisory approaches, such as encouraging banks to increase capital, to strengthen that fabric over time.

And, of course, the challenge remains to reach appropriate judgments on growth in money and credit, with the objective of encouraging sustainable growth at more stable prices. I have spoken of our plans, and I am prepared to address your questions on that matter today.

But I first want to emphasize the success of all those approaches -- and they plainly are within our capacity as a nation -- are dependent on each other. No monetary policy can work without strains in the face of deficits that preempt so much of our savings as the economy is more fully employed -- and, of course, efforts in fiscal and trade policy must presume a prudent monetary policy consistent with stability and growth.

In the areas of our responsibility -- both monetary and supervisory policy -- we are working toward that end. We count on progress in other directions as well. The facts with respect to growth and inflation for more than a year demonstrate that we all have much upon which to build. But there are also clear signals that -- far from basking in the warmth of past and present progress -- the strongest kind of effort will be necessary to convert potential success into sustained growth and stability.

Table I

Economic Projections for 1984 and 1985*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
1984		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	9-1/2 to 11-1/2	10-1/2 to 11
Real GNP	6 to 7	6-1/4 to 6-3/4
Implicit deflator for GNP	3-1/4 to 4-1/2	4 to 4-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/2 to 7-1/4	6-3/4 to 7
1985		
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-3/4 to 9-1/2	8 to 9
Real GNP	2 to 4	3 to 3-1/4
Implicit deflator for GNP	3-1/2 to 6-1/2	5-1/4 to 5-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/4 to 7-1/4	6-1/2 to 7

*The Administration has yet to publish its Mid-session Budget Review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals is not included in this report.

Table II

Growth Ranges Reconfirmed for 1984 for Money and Debt Compared with Actual Growth through June '84

	Ranges	Actual Growth QIV '83 to June '84
M1	4 to 8	7.5
M2	6 to 9	7.0
M3	6 to 9	9.7
Debt 1/	8 to 11	13.1 e/

Note: Growth ranges pertain to period from QIV '83 to QIV '84.

e/ Estimated.

Tentative Growth Ranges Adopted for 1985

M1	4 to 7
M2	6 to 8-1/2
M3	6 to 9
Debt 1/	8 to 11

Note: Growth ranges pertain to period from QIV '84 to QIV '85.

1/ Domestic nonfinancial sector debt.

Table III

GROWTH IN DOMESTIC NONFINANCIAL DEBT
(Seasonally adjusted annual rates, percent)

	QIV: 1983 to QII: 1984 1/
Total	13.1 2/
Federal	14.6
Other	12.6
Selected Categories	
Home Mortgages	11.7
Consumer Credit	18.4
Short-term Business Borrowing	15.6

1/ Based on quarterly average flow of funds data. QII: 1984 partly estimated.

2/ Adjusted for the credit used in corporate mergers and buyouts, it is estimated that growth in domestic nonfinancial debt would be about 12 percent (SAAR) over the first half of 1984.

FOR USE AT 9:30 A.M., E.D.T.
WEDNESDAY
JULY 25, 1984

Board of Governors of the Federal Reserve System

Midyear Monetary Policy Report to Congress Pursuant to the Full Employment and Balanced Growth Act of 1978

July 25, 1984

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM
Washington, D.C., July 25, 1984

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES.

The Board of Governors is pleased to submit its Midyear Monetary Policy Report to the Congress pursuant to the Full Employment and Balanced Growth Act of 1978.

Sincerely,
Paul A. Volcker, Chairman

Section 1: The Outlook for the Economy

As reviewed in later sections of this report, the nation's economy in the first half of 1984 was characterized by marked strength in sales, production, and employment and by relatively low inflation. Moreover, economic activity still appeared to have substantial forward momentum at midyear, and the strong growth of the U.S. economy was helping to encourage recovery abroad as well. Amid the favorable overall performance, however, some important structural imbalances and financial strains were apparent that need attention lest they impair the sustainability of orderly growth. In particular, extraordinary increases in domestic demand have been accompanied by a further deterioration of our trade and current account deficits, which has contributed to dangerous protectionist pressures. The persistent strength of the dollar in foreign exchange markets has helped to keep inflation quiescent, but that strength has been dependent on a pattern of massive capital inflows. Interest rates, under pressure from the combined credit demands of the federal government and the rapidly growing private sector, have risen from what already were high levels historically, adding to stresses on some sectors of the U.S. economy and on heavily indebted foreign countries. As labor and capital resources have become much more fully utilized, and as real growth has continued exceptionally rapid, the possibility of demand pressures contributing to renewed inflationary tendencies has become a concern to many.

For the near term, the prospects for continuing good gains in economic activity appear favorable. Consumers seem to be willing to spend, and they have the wherewithal to do so. The rising trend of contracts and orders points to further sizable increases in business plant and equipment spending. And inflation should remain relatively subdued in the period immediately ahead, given the recent behavior of labor and material costs.

However, as we look beyond the near term, the stresses and imbalances in the economy give rise to significant uncertainties in assessing the economic and price outlook--and pose substantial challenges for public policy. The members of the Federal Open Market Committee recognized this fact as they prepared their economic projections for the remainder of 1984 and for 1985 at their meeting earlier this month, emphasizing that the probability of maintaining highly satisfactory performance could only be assured by timely decisions in a number of public policy areas. In formulating its own policy plans, the Committee agreed that, while flexibility and sensitivity might be required in conducting monetary policy during this crucial period, Federal Reserve policy would need to remain basically oriented toward encouraging growth in a context of maintaining progress over time toward price stability. The specific monetary objectives outlined in the next section provided part of the assumptions underlying the projections.

At this time, the members of the FOMC (including those Reserve Bank presidents who are not at present voting members) generally foresee appreciable gains in economic activity over the remainder of 1984, but with growth of real GNP less rapid than in the first half of the year. While clear evidence of substantial moderation in the pace of expansion is still limited, some slowing seems likely in light of some softening of demand in the housing market, some probable tendency for inventory investment to level off after a sharp surge in the first half, and other factors. The central tendency of

Committee members' forecasts is for an increase in real output of about 6-1/2 percent for the year as a whole. The unemployment rate, which averaged about 7-1/2 percent in the second quarter of 1984, is expected to fall further in coming months, although much will depend on the highly uncertain behavior of labor force participation rates and productivity growth, as well as on the strength of demand in the economy. The implicit deflator for gross national

Economic Projections for 1984 and 1985*

	FOMC Members and other FRB Presidents	
	Range	Central Tendency
	1984	
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Real GNP	6 to 7	6-1/4 to 6-3/4
Implicit deflator for GNP	3-1/4 to 4-1/2	4 to 4-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/2 to 7-1/4	6-3/4 to 7
	1985	
Percent change, fourth quarter to fourth quarter:		
Nominal GNP	6-3/4 to 9-1/2	8 to 9
Real GNP	2 to 4	3 to 3-1/4
Implicit deflator for GNP	3-1/2 to 6-1/2	5-1/4 to 5-1/2
Average level in the fourth quarter, percent:		
Unemployment rate	6-1/4 to 7-1/4	6-1/2 to 7

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*The Administration has yet to publish its Mid-session Budget Review document, and consequently the customary comparison of FOMC forecasts and Administration economic goals is not included in this report.

product is expected to rise slightly faster than in the first half of 1984, but even so, the central tendency of Committee members' inflation forecasts shows an increase for the year that--at around 4-1/4 percent--would be only slightly above the 1983 rise and would be lower than generally expected at the start of this year.

Members of the FOMC believe that growth in activity is likely to continue in 1985, though at a slower pace. That slower pace would be satisfactory to the extent it reflected the settling of the economy into a sustainable pattern of longer-run expansion after a rebound from an exceptionally deep recession. Specifically, the central tendency of FOMC forecasts calls for real growth of 3 to 3-1/4 percent next year and some further decline in the unemployment rate. The Committee expects price increases to be somewhat larger in 1985 than this year, with the central tendency of members' forecasts being 5-1/4 to 5-1/2 percent, on the assumption that the dollar remains in the trading range of the past year or so; the expectation of some pickup in price increases in fact reflects in part the assumption that the inflation-damping influence of dollar appreciation will abate, but on the basis of past experience some cyclical pressures on wages and prices might also be anticipated as a result of reduced slack in labor and product markets.

The behavior of the dollar in foreign exchange markets is only one of the uncertainties in the outlook for 1985. Strains in financial markets have been aggravated by the historically large current and prospective federal budget deficits, and international debt problems will continue to require attention. With respect to the federal budget, Committee members are assuming that Congress and the Administration will soon complete action on a series of measures that represent an initial "down payment" toward reducing current and prospective federal budget deficits. Although no specific assumptions were made regarding further deficit-reducing steps in 1985, it was recognized that additional, substantial budgetary actions will be needed to enhance the prospects for sustained, orderly economic growth.

Section 2: The Federal Reserve's Objectives for Growth of Money and Credit

The Federal Open Market Committee has reviewed its target ranges for 1984 and established tentative ranges for 1985 in light of its objective of achieving sustained growth in the context of continuing progress toward reasonable price stability over time. The behavior of M1 and M2 in the first half of 1984 was broadly consistent with the Committee's expectations and objectives. Although difficulties in anticipating demands for various measures of money and credit under changing economic circumstances remained, partly reflecting the new deposit accounts introduced in the recent period of deregulation and changing financial practices, no developments were foreseen that would call for changes in the 1984 targets for M1 and M2. Consequently, the Committee reaffirmed the existing target ranges for 1984 for those aggregates.

M3 expanded above its target range and domestic nonfinancial sector debt ran well above its monitoring range during the first half of the year. The unexpectedly brisk expansion of spending appears to be a factor influencing credit expansion. But in addition, this rapid growth is partly attributable to the unusual amount of corporate mergers and buyouts, which also have led to a sharp reduction in corporate equity shares outstanding. Some of this rapid debt expansion may have influenced M3, as banks issued CDs, for example, to finance credit expansion, though it is always difficult to evaluate how institutions or depositors would have behaved if circumstances had differed.

It appears that the factors that led to growth in M3 and debt above the upper limits of their ranges in the first half could be less important during the second half. Credit flows associated with corporate acquisition activity should diminish, partly because of higher prevailing interest rates and partly because of greater caution on the part of lenders in evaluating the soundness of proposed transactions. It also seems likely that growth of household spending and consumer and mortgage credit demands will moderate somewhat. However, given the levels of the money and credit aggregates at midyear, it is unlikely that M3 and debt will be within their ranges by year-end, although it is expected that some deceleration toward the upper limits of the ranges will occur.

Under the circumstances, the Committee considered the question of whether increases in the ranges for 1984 for M3 and domestic nonfinancial sector debt would be appropriate. On balance, the Committee was of the view that the broad direction of policy would best be communicated by retaining the current range for M3 and the associated monitoring range for domestic nonfinancial sector debt. While the Committee anticipated growth somewhat above their ranges for the year as a whole, it was felt that higher "target" ranges would provide an improper benchmark for evaluating desired longer-term trends in these aggregates.

The Committee also discussed the ranges for the aggregates to be established on a tentative basis for 1985. The Committee reaffirmed its intention to lower over time growth of money and credit to rates appropriate to progress toward price stability in an environment of sustainable economic growth. Consistent with these goals, the FOMC established tentative ranges for M1 and M2 that were somewhat below those for 1984. For M1, the upper limit was lowered by one percentage point, and the range was set at 4 to 7 percent. For M2, the upper limit was lowered by one-half point, and a tentative 6 to 8-1/2 percent range was established.

The width of the M1 range was brought more in line with the dimensions of the ranges for the other aggregates. This reflected experience over the past year in which the behavior of M1 has been more consistent with previous cyclical patterns than was the case in the recent recession. Consequently, the Committee felt that it would be appropriate to give roughly equal weight to all of the monetary aggregates in implementing policy. Nonetheless, it was recognized that uncertainties remained about the behavior of M1, as well as of the other aggregates, in periods of changing market conditions. For instance, should market interest rates change considerably, it is possible that funds would flow quickly into or out of such fixed interest deposits as NOW accounts, leading to sizable movements in M1--but, with limited experience to date with the present account structure, the extent of these movements cannot be projected with confidence. Moreover, the process of financial deregulation continues. At the beginning of 1985, the minimum denomination on Super-NOW accounts and MMDAs is scheduled to decline from $2,500 to $1,000; it was assumed that this will have no more than a minimal impact on M1 and M2. Should legislative action permit interest on reserves or on demand deposits, this would tend to affect--perhaps significantly--the demand for monetary aggregates, particularly M1.

The Committee retained for 1985 the current target range for M3 and the current monitoring range for domestic nonfinancial sector debt. As noted above, these aggregates might be somewhat above their ranges in 1984. Thus, growth next year within their ranges would represent an actual slowing from this year's pace. The Committee noted that some deceleration in growth of these aggregates is both desirable and likely, reflecting a slowing in expansion of nominal GNP and a drop in corporate merger activity. Still, business demands for external finance are likely to remain strong, and absent a substantial improvement in the stock and bond markets would tend to continue to be concentrated at banks and in short-term credit markets generally. Although household borrowing is expected to moderate somewhat in 1985, state and local government borrowing may be heavier than in 1984 and the federal budget implies the continuation of exceptionally large Treasury borrowing.

In its discussion, the Committee noted that only limited progress has been made recently in reducing federal budget deficits, and that current and prospective structural deficits remain huge. The massive fiscal stimulus and credit demands associated with these structural deficits will tend to hold interest rates at high levels. Further progress in lowering the deficit would help to relieve credit market pressures.

The Committee felt that implementation of monetary policy would require continuing appraisal of the progress of economic activity and prices and of conditions in domestic and international financial markets--especially in light of the sensitive state of these markets and of a number of economic sectors. The Committee emphasized, however, the importance of appropriate restraint in monetary and credit growth. A good start has been made in reversing the debilitating trends of rising inflation and languishing productivity that plagued our economy for so many years. But monetary vigilance--in combination with determined action to reduce the federal presence in the credit markets--is essential to the achievement of durable reductions in interest rates, overall financial and economic stability, and sustained growth of the economy.

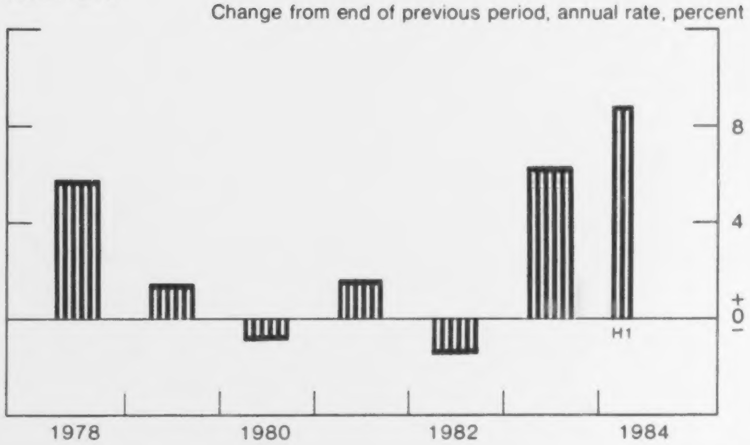
Section 3: The Performance of the Economy in the First Half of 1984

The economic expansion gained further momentum in the first half of 1984, as the growth of real gross national product accelerated to an annual rate of almost 9 percent. Employment also increased rapidly, and the unemployment rate dropped to its lowest level in more than four years. Price increases continued to be relatively moderate.

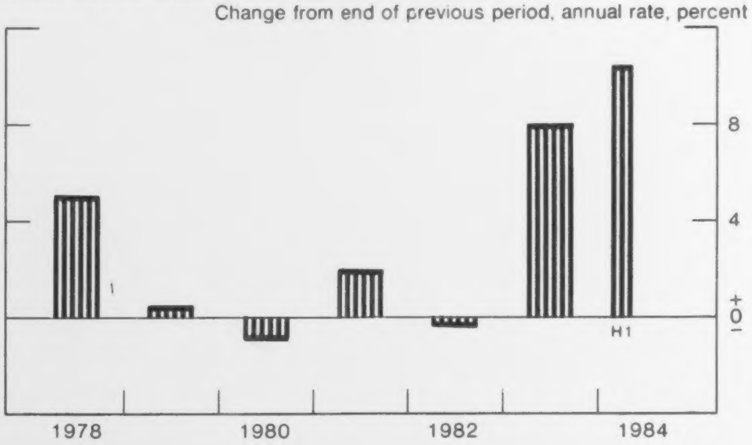
In 1983, the economy had followed a path that was fairly typical of previous postwar recoveries; with the continued rapid growth of activity in 1984, the current expansion has proved stronger than during comparable cyclical periods since World War II, the only exception being the period of the Korean War buildup. Real GNP has grown faster, and the levels of economic slack have declined more rapidly, than in the usual expansion. In addition, real gross domestic spending rose even more rapidly than production during the first half--about 10-1/4 percent at an annual rate--and was reflected in a surge in the demand for imports as well as strong demands for the goods and services being produced domestically. These gains, of course, followed a deep recession. The civilian unemployment rate at midyear--at just over 7 percent--had dropped about 3-3/4 percentage points from its peak, but is still above "full employment" levels. The capacity utilization rate in manufacturing is slightly below the postwar average.

The strong growth, reduced unemployment, and more stable prices of the past year and a half have been reflected in rising productivity and higher real incomes for most Americans. After the immediate hardships associated with the recession, progress toward our long range goals has been apparent. Even

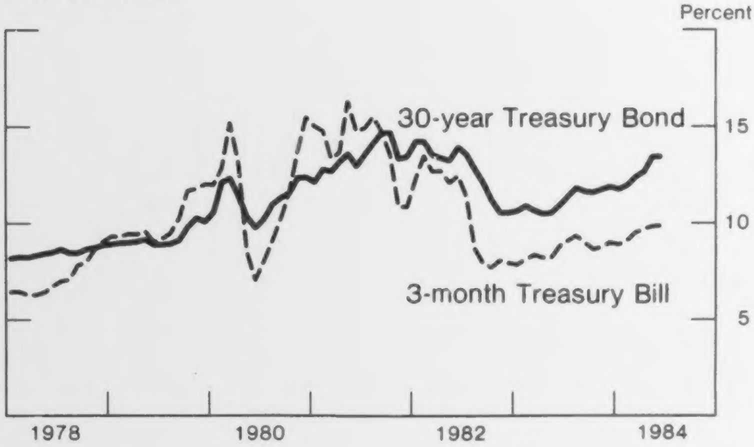
Real GNP



Real Gross Domestic Purchases



Interest Rates



so, the economy still faces a number of serious problems and, in some respects, these problems have grown more worrisome over time. During the current expansion, there has been an enormous increase in federal debt and an unprecedented deterioration in our balance of trade. A number of domestic producers have not shared fully in the expansion, and many developing nations still are burdened by large external debts. Concern about financial stress in both the domestic and international economies has heightened this year as interest rates have risen from levels that already were high by historical standards.

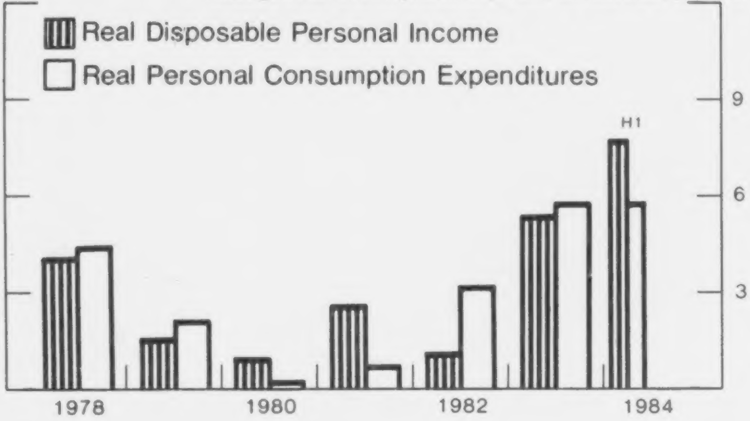
Widespread concern about the outlook for inflation also persists, despite the continuation of favorable wage and price patterns through the first half of 1984. One cause for concern is that growth in the demands placed on the economy could continue at a pace that, if maintained for long, would damage the prospects for sustaining real growth, achieving better balance in financial markets, and making further progress toward price stability--central objectives of public policy. Inflationary pressures would be intensified if the exchange value of the U.S. dollar were to decline sharply from its current high level in the face of unprecendentedly large current account deficits. These concerns are importantly related to the strains on real and financial markets stemming from federal budget deficits, actual and potential, which, among other implications, now complicate the conduct of monetary policy.

The Household Sector

Strength in the household sector continued to provide a strong impetus for expansion in the first half of 1984. Personal income, in nominal terms, rose at about a 10-3/4 percent annual rate during the first half of the

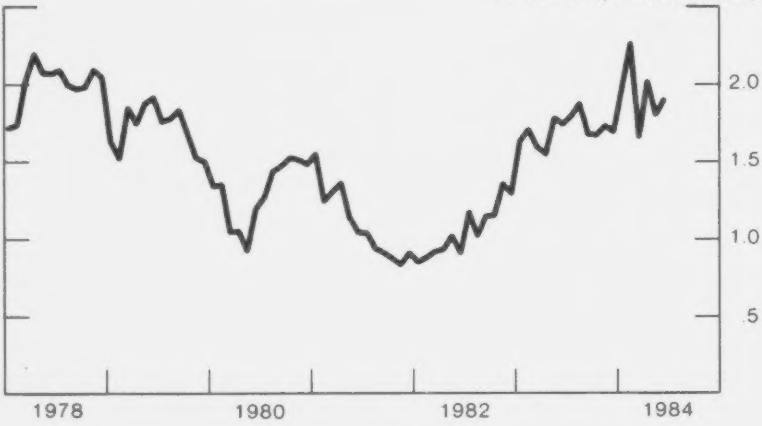
Real Income and Consumption

Change from end of previous period, annual rate, percent



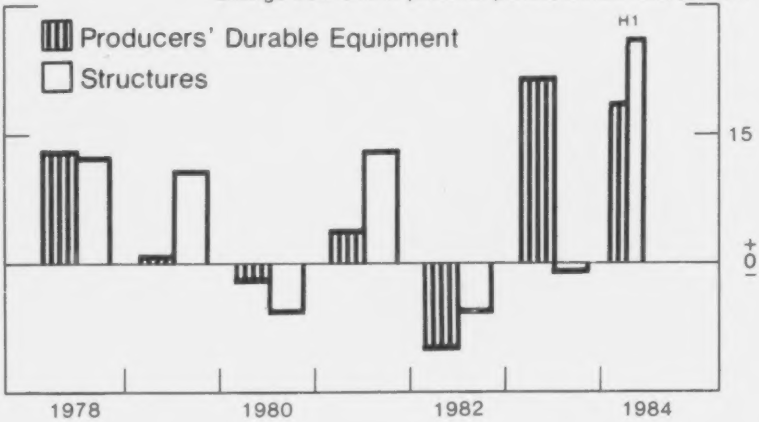
Total Private Housing Starts

Annual rate, millions of units



Real Business Fixed Investment

Change from end of previous period, annual rate, percent



year, and with inflation low, most of that nominal gain translated directly into sizable increases in real purchasing power. In addition, despite the recent upswing in interest rates and some decline in stock market wealth, consumers remain generally optimistic about future business conditions. Reflecting that optimism, they have continued to consume heavily out of current income and have become increasingly willing to take on higher levels of debt. As a result, personal consumption expenditures, in real terms, rose rapidly in the first half of 1984--at an annual rate of nearly 6 percent.

Consumer spending for new cars was particularly robust in the first half of 1984 as unit auto sales rose to the highest level since mid-1979. With quotas limiting the imports of foreign models, most of the rise in spending was channeled into sharply higher purchases of domestically produced automobiles, and in light of strong sales, many domestic auto plants operated near full capacity in the first half of 1984. Auto output, in real terms, was about 50 percent above the depressed level of 1982.

Spending for housing also continued to advance in the first half of 1984, thereby maintaining the vigorous cyclical expansion that was apparent during 1983. Housing starts spurted to a six-year high in January and February, and outlays for residential construction rose in both the first and second quarters. All told, the rebound in housing activity over the past year and a half has been stronger than generally expected and has exceeded the gains experienced during most previous housing recoveries. During this period, demographic influences and relatively stable house prices provided underlying support for housing demand, and innovations in housing finance helped to soften the effect of high mortgage interest rates. While home sales appeared to be moving lower toward midyear, there should continue to be a supporting influence in housing markets from some of the same factors that have helped to boost activity to a high level during the early phases of the expansion.

Household balance sheets are no longer strengthening as they did during the recession and early phases of the recovery. Some of the earlier gains in stock market wealth have been reversed during this year's decline in stock prices, and household debt has been growing much more rapidly than in 1983. In addition, there are troubling aspects to some of the recent patterns of household credit growth. Consumer credit has been rising much faster than income this year, and some of the recent innovations in mortgage lending, while supportive of current housing activity, also increase the level of borrower exposure to adverse movements in interest rates or unexpected shortfalls in future household incomes.

The Business Sector

Economic conditions in the business sector have strengthened during the past year and a half. Output, sales, profits, productivity, and investment spending have all been rising throughout the expansion. By the first quarter of 1984, after-tax profits in the domestic nonfinancial corporate sector were about twice the levels of late 1982. Fixed investment spending, in real terms, has risen roughly 25 percent during the first year and a half of the recovery.

The rise in business investment spending during the current expansion has been much stronger than generally expected. Unused capacity was at a particularly high level when the expansion began and appeared likely to inhibit new capital outlays for some time. However, as the economic expansion started to look more durable during the course of 1983, businesses began rushing to modernize old units or to add to capacity. In addition, other factors, such as the 1982-83 stock market boom and changes in tax laws, contributed to the ebullience in investment spending. The widespread adoption of new computer-based technologies, which was evident even during the recession, also has continued to provide an element of strong support in the capital goods sector, and, more generally, businesses have recognized a need to invest in new technologies in order to remain competitive with foreign producers. Reflecting these influences, spending for new capital equipment recorded particularly strong gains during the past year and a half, and spending for structures also has strengthened markedly in recent quarters.

Inventory accumulation during 1983 was less rapid than in the early phases of many previous recoveries, but, in light of lengthening delivery times and the sustained strength of sales, businesses appear to have become more willing to rebuild stocks in the first half of 1984. In real terms, business inventories rose at more than a $30 billion annual rate in the first quarter of the year, and a further sizable accumulation was apparent in the second quarter. Even so, stocks in most industries still appear lean relative to the recent pace of sales.

Despite the impressive improvement in activity over the past year and a half, businesses have not restored their financial ratios to positions comparable to pre-inflation and pre-recession levels. As is typical in the early phases of economic expansions, many businesses began moving to strengthen their balance sheets in 1983, but the period of balance sheet restructuring in the current expansion appears to have been unusually brief. A downturn in stock prices this year has made equity financing less attractive, and rising long-term interest rates have inhibited bond financing. Mergers and so-called "leveraged buyouts" have resulted in a disturbing net retirement of equity so far this year. The business sector has remained heavily reliant on short-term credit as its source of finance and is still relatively vulnerable to adverse interest-rate developments.

Financial problems of a more severe nature are evident in particular sectors of the economy. In farming, for example, export developments have continued to be discouraging, land prices are falling in important agricultural areas, and many farmers that had accumulated large volumes of debt during the more inflationary years are, at present, facing severe financial strains.

The Government Sector

With the cyclical strengthening in economic activity, federal tax revenues have increased and the rate of growth in federal spending for income support programs has slowed markedly. Nevertheless, federal debt has continued to accumulate at an enormous rate, reflecting both an underlying uptrend in federal outlays and the series of tax reductions that took effect during the past three years. Federal debt outstanding has risen more than 80 percent since the end of 1979. Net interest payments on the debt have more than doubled over than same period, rising to an annual rate of about $110 billion by the first half of 1984. Current prospects are for further sizable increases in both outstanding debt and net interest payments in coming years.

These spending and revenue policies of the federal government have provided an extraordinary stimulus to aggregate demand for goods and services, but they also have contributed to high interest rates, unsettled conditions in financial markets, and a startling deterioration in our balance of trade. Recognizing the dangers posed by current policies, Congress and the Administration have sought appropriate ways to reduce federal budget deficits, but the actions taken to date are only a limited beginning toward dealing with the full magnitude of the problem.

The underlying thrust toward higher federal spending has been obscured in some of the recent data. For example, in real terms, federal purchases of goods and services in the first half of 1984 were slightly below year-earlier levels as outlays early in the year were depressed by an unusually rapid liquidation of the farm inventories held by the government's Commodity Credit Corporation. For other goods and services, federal purchases in the first half were nearly 4 percent above a year earlier, after adjustment for inflation. Real outlays for defense were up about 5-1/4 percent from a year earlier.

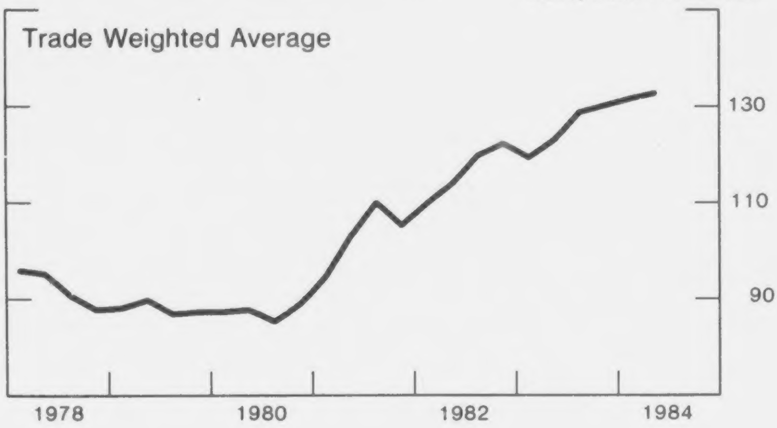
The financial situation of state and local governments has improved markedly during the expansion. In real terms, state and local outlays, though up moderately in the first half of 1984, still have shown only a small real gain over the past three years as a whole; these cautious spending patterns, coupled with increased tax revenues associated with the expansion, have resulted in large operating surpluses for state and local governing units as a whole.

The Foreign Sector

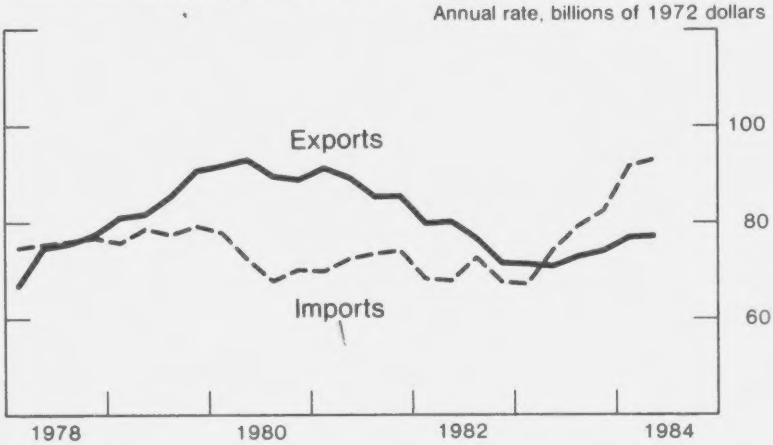
After falling sharply in 1981 and 1982, the volume of U.S. exports rose moderately during 1983 and increased further in the early part of this year. However, imports have grown much faster, and as a result the trade deficit increased from an annual rate of roughly $40 billion in the first quarter of 1983 to a rate of more than $100 billion in the first quarter of 1984. The U.S. current account deficit registered a corresponding shift during this period, with the first quarter deficit reaching an annual rate of nearly $80 billion. Data through May indicate that the trade balance remained weak into the second quarter. The magnitudes of these trade and current account deficits are without historical precedent.

While the gains in exports in recent quarters have not fully reversed the declines that occurred during the last recession, imports have surged far above their pre-recession peak. A major influence on these trade patterns has been the tremendous appreciation in the exchange value of the U.S. dollar in recent years. Buoyed by high U.S. interest rates and an eagerness of foreigners to invest in dollar-denominated assets, the dollar rose by about 45 percent against other currencies from late 1980 to late 1983 and, after turning down temporarily in early 1984, rose to new highs around midyear. This appreciation, through its impact on relative prices, has been both a depressant of exports and a strong stimulant to import growth.

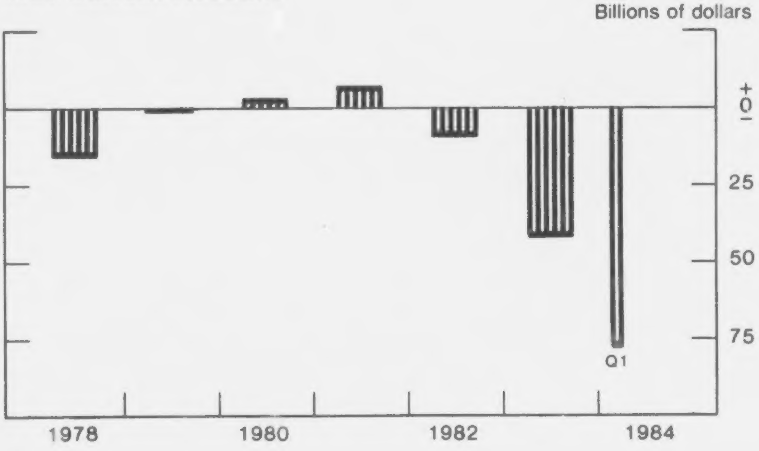
Recent trade developments also reflect the sharply divergent growth patterns in the world economy. The exceptional strength of the U.S. economy over the past year and a half has been manifested partly in a surge of import buying. In contrast, the economic recovery in other industrial nations has



Exchange Value of the U.S. Dollar



U.S. Real Merchandise Trade Volume*



U.S. Current Account

*1984 Q2 is average of April and May.

been substantially *less rapid than in the United States*, and exports to those nations have lagged. Many developing countries that are burdened with huge external debts have, necessarily, sharply constrained imports, including those from the United States.

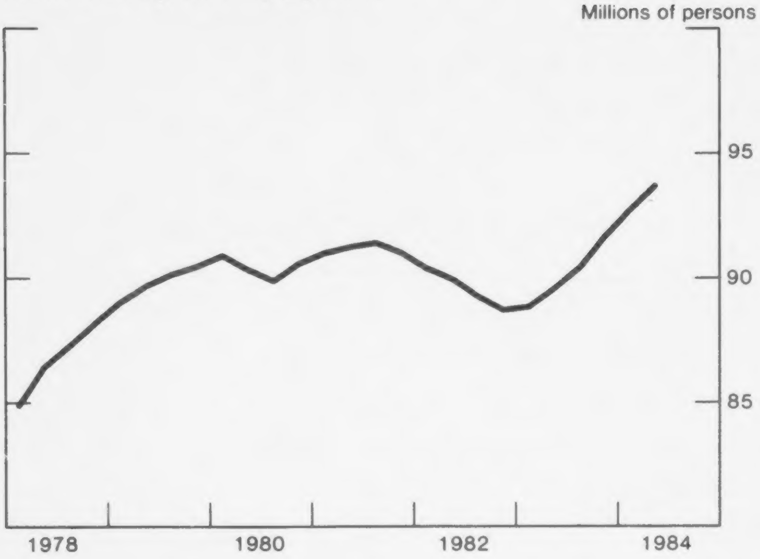
Labor Market Developments

Labor market developments in the first half of 1984 were shaped both by the vigorous expansion in economic activity and by widespread restraint on increases in nominal wages and salaries. Employment rose rapidly, work schedules lengthened, and unemployment declined. Thus far in the current expansion, payroll employment has risen a little more rapidly than in most previous postwar recoveries; the average workweek, another indicator of labor demand, has increased much faster than usual.

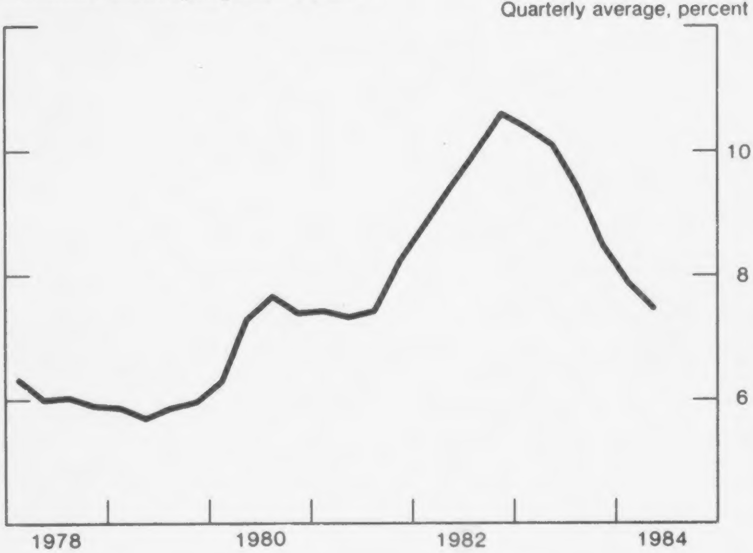
The slack economic conditions during the recession and the early phases of the recovery may have discouraged many persons from seeking new jobs, but as the expansion has lengthened into 1984, new jobseekers started entering the labor force at a faster pace. However, employment opportunities rose even faster and, as a result, unemployment rates continued to fall. By June the civilian unemployment rate had dropped to nearly 7 percent, its lowest level since April 1980.

Notwithstanding the general improvement in labor market conditions, there are wide disparities in the job situations across different regions. Unemployment is still quite high in many of the traditional industrial states, and problems of longer-term unemployment remain especially acute in communities in which plants were permanently closed during the recession. Jobless rates for blacks and teenagers also remain exceptionally high.

Nonfarm Payroll Employment



Civilian Unemployment Rate



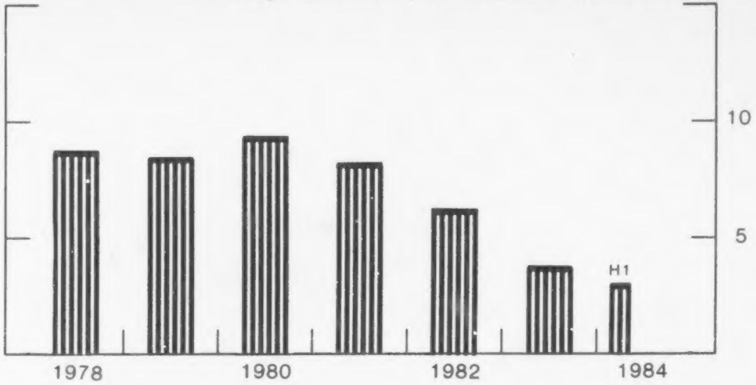
Recent wage developments appear to have been affected both by changes in behavior that first were evident during the recession period and by the moderation of price increases. Nominal wage increases, which were running close to 10 percent per year at the start of the decade, fell sharply in 1982 as unemployment rose to nearly 11 percent of the labor force. As the economy has expanded, the rate of wage increase has remained close to those lower levels. Year-to-year increases in the employment cost index, a fairly comprehensive measure of wage and benefit change, held at about the 5-3/4 percent mark from September 1983 through March 1984; the hourly earnings index, a measure of wage change for production and nonsupervisory workers, has slowed a little further in the first half of this year to an annual rate of about 3-1/4 percent.

By the 1970s, large annual increases in nominal wages had become almost automatic in a number of industries, thereby imparting strong momentum to the inflationary process. However, as labor markets weakened in the early 1980s and price expectations moderated, there were marked changes in patterns of wage determination. Outright declines in wages occurred in many troubled industries, and workers in general became more concerned about job security than about automatic wage increases. Workers and managers alike took new interest in measures to improve productivity and to enhance competitiveness in foreign markets.

With labor markets now tightening, a key question in the outlook is whether the recent conservative patterns of wage determination will be maintained, or alternatively, whether there will be a reversion to the more inflationary patterns of the previous decade. Important signs regarding the

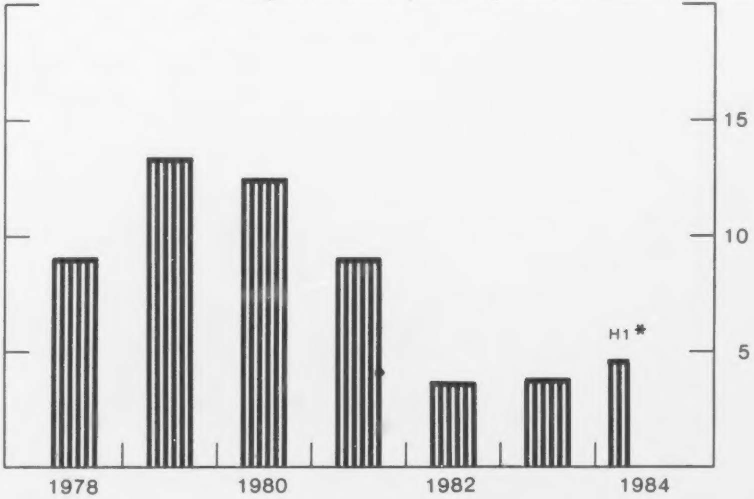
Hourly Earnings Index

Change from end of previous period, annual rate, percent



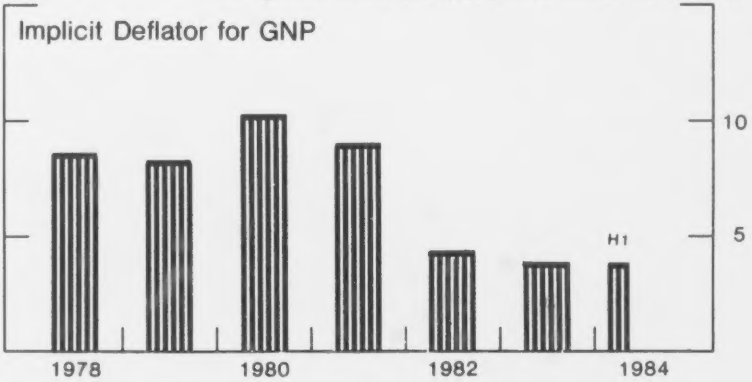
Consumer Price Index

Change from end of previous period, annual rate, percent



GNP Prices

Change from end of previous period, annual rate, percent



*Consumer price change for 1984 H1 is based on December to May period.

outlook for wages should emerge later this year, as new collective bargaining negotiations get under way, including some in industries in which economic conditions have strengthened markedly during the expansion.

Price developments

Inflation rates fell dramatically during 1982 and--by the standards of the past decade--have remained relatively moderate through the first year and a half of the expansion. The consumer price index rose at an annual rate of about 4-1/2 percent during the first five months of 1984; the price deflator for gross national product was up at a rate of only 3-3/4 percent in the first half. The rate of increase in the CPI was slightly above the pace experienced during 1983; the GNP deflator has risen at the same rate this year as in 1983. Producer prices, after rising only fractionally in 1983, increased at close to a 3 percent rate in the first half of this year; basic commodity prices have been declining in recent weeks, reversing some of the sharp advances that occurred earlier in the expansion.

Taken together, these and other price data suggest that inflation in the first half remained in the range that has generally prevailed since early 1982 and is running at little more than one-third of the peak inflation rates of the 1979 to 1981 period. Price behavior over the past year and a half has been constrained by highly competitive markets, as well as by the ample plant capacity and labor resources generally available during the recovery period. In addition, because of the sharp rise of the dollar in exchange markets, the dollar prices of imported goods have increased only slightly thus far in the expansion and have been a greater restraining influence on domestic prices than in past expansions.

Imbalances between supply and demand have been an important influence on price developments in food and energy markets, sectors in which inflationary pressures had been particularly acute in the 1970s. Because of spare capacity in world oil markets, a protracted war in the Persian Gulf has, to date, had little effect on the prices of oil or petroleum products; consumer energy prices, in relative terms, have continued to decline this year. Similarly, the slack export demand for U.S. farm products has helped to damp price pressures in the food sector; despite the severe drought of last summer and a damaging freeze this past winter, the rise in consumer food prices in the first half of the year was not much different than the general rate of inflation.

All told, the nation is enjoying a better price performance than for any sustained period in more than a decade. The fact that inflation rates and underlying wage trends have remained moderate during a particularly robust expansion is an encouraging development. However, there typically has been little price acceleration in the first two years of business expansions; the dangers have become greater in the later stages of expansion. Moreover, while the foreign sector has provided an important restraining influence on domestic prices thus far in the current expansion, that influence has been dependent on an exceptionally strong dollar and a high level of capital inflows from abroad. Thus, although current price trends are favorable, important tests of progress toward greater price stability remain ahead.

Section 4: Money, Credit, and Financial Markets in the First Half of 1984

Earlier this year, the Federal Open Market Committee established spcific growth objectives for the monetary and credit aggregates for 1984. These objectives were 4 to 8 percent for M1, 6 to 9 percent for both M2 and M3, and 8 to 11 percent for domestic nonfinancial sector debt. The ranges were set 1/2 or a full percentage point below the ranges for 1983, to be consistent with continued restraint on inflationary pressures while encouraging sustainable expansion in economic activity.

In setting these objectives, the FOMC assumed that special factors that had contributed to strong demands for money in 1982 and 1983 would not be nearly so important in 1984. The massive shifts of funds brought about by the introduction of the new deposit accounts were largely completed last year. The continuing strength of the economic rebound and the size of federal budget deficits made it appear that further substantial declines in interest rates, such as those that had accompanied the recession in 1982 and had contributed to sharp declines in monetary velocity, were unlikely over the near term. Moreover, greatly improved prospects for employment and incomes seemed to be reducing the uncertainties that earlier had swelled demands for precautionary balances. Consequently, the relationships of the monetary aggregates to income and interest rates were expected to fall more into line with historical norms.

Even though, as 1984 began, there was some evidence that the velocity of M1 was behaving more in accord with past patterns, the Committee decided that it would not yet be appropriate to place full weight on that aggregate as a policy guide and that its growth would need to be interpreted in light of growth in the other aggregates. Moreover, growth of all the aggregates needed to be appraised in the context of the outlook for economic activity and prices, and over-all credit market developments.

In the first part of the year, credit demands proved to be exceptionally strong, reflecting the continued rapid expansion in private sectors of the economy, coupled with sustained, large federal borrowing needs. Indeed, growth in the debt of domestic nonfinancial sectors accelerated in the first quarter and remained at an advanced pace of around 13 percent at annual rate through the first half, significantly above the range set by the FOMC at the beginning of the year. The debt of private sectors increased at about 12-1/2 percent annual rate in the first half of the year--some 4-1/2 percentage points more than last year--while federal debt expansion remained strong at around a 14-3/4 percent annual rate.

In appraising credit growth over the first half of the year, account needs to be taken of an unusually large volume of merger activity. Several large mergers and many smaller ones were financed largely with debt, and led to liquidation of a sizable amount of equity. Such mergers are estimated to have accounted for roughly one percentage point of the annual growth rate of domestic nonfinancial sector debt in the first half of the year.

Much of the debt expansion was concentrated in short-term markets. Bank credit growth accelerated to a 14 percent annual rate in the first quarter of the year, though growth slowed somewhat in the spring as banks liquidated securities to a greater extent in accommodating loan demands. Large amounts of credit also were raised in the commercial paper market.

GROWTH OF MONEY AND CREDIT
Percentage changes

Period	M1	M2	M3	Domestic nonfinancial sector debt
Fourth quarter to June 1984	7.5	7.0	9.7	13.1[e]
Fourth quarter to second quarter 1984	6.7	6.9	9.7	13.1[e]
Fourth quarter to fourth quarter				
1978	8.2	8.0	11.8	13.3
1979	7.5	8.1	10.3	12.1
1980	7.4	9.0	9.6	9.6
1981	5.1 (2.5)[1]	9.3	12.3	9.9
1982	8.7	9.5	10.5	9.0
1983	10.0	12.1	9.7	10.8
Quarterly growth rates				
1983--Q1	12.8	20.5	10.8	8.9
Q2	11.6	10.6	9.3	10.4
Q3	9.5	6.9	7.4	11.8
Q4	4.8	8.5	9.8	10.3
1984--Q1	7.2	7.0	9.0	12.5
Q2	6.1	6.8	10.2	13.3[e]

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e--estimated.

1. M1 figure in parentheses is adjusted for shifts to NOW accounts in 1981.

Corporate borrowers--which as a group had not had any significant need for net external financing in the previous two years--this year began to experience a rise in the financing gap, as spending for inventories and plant and equipment came to outpace internally generated funds.

While borrowing in short-term markets particularly strengthened, the demand for funds in longer-term debt markets remained large relative to the supply of savings into those instruments. Mortgage borrowing by households rose sharply, and corporate bond issuance picked up somewhat from its pace of the second half of last year. Meanwhile, the federal government continued to market a sizable amount of longer-term debt obligations to meet its continuing large cash needs and to roll over maturing debt. On the other hand, activity in the municipal bond market was subdued during the first half, at least by comparison with the past two years, reflecting a lapse in authority to issue mortgage revenue bonds and anticipated legislative limits on industrial development and student loan bonds retroactive to January.

The strength of total credit demands exerted upward pressures on interest rates. These pressures were reflected in about a 1 to 2 percentage point rise in short-term rates over the first half of the year. Long-term rates also rose by about that amount, reflecting in part the weight of Treasury financing and uncertainties about the budgetary and economic outlook generally, whereas they normally rise by much less than short-term rates.

The Federal Reserve in implementation of monetary policy added moderately to pressures on the reserves of the banking system around the end of the first quarter to maintain appropriate growth of money and credit. To meet credit demand and deposit growth, institutions had to turn somewhat more to the discount window; borrowing for adjustment and seasonal purposes at the window rose to around $1 billion in March and April after averaging only about $640 million during the first two months of the year. The narrower monetary aggregates--M1 and M2--have remained within their ranges. However, under the pressure of strong public and private credit demands both M3 and total domestic credit have been expanding at a more rapid rate than anticipated.

As reserve pressures increased, growth of total reserves and the monetary base slowed substantially during the early spring. Part of the slowing in growth of total reserves reflected the return of excess reserves to more usual levels after they had expanded sharply in February, at the time of the introduction of contemporaneous reserve accounting. In May and June, growth in the reserve aggregates accelerated, partly reflecting the upward impact on required reserves of shifts in the deposit mix as banks relied relatively more heavily on large time deposits and as government and interbank deposits also rose. The large borrowing by Continental Illinois Bank over this period was offset in open market operations by reduced holdings of U.S. Government securities, so that borrowing by depository institutions apart from that bank remained close to the level reached in early spring.

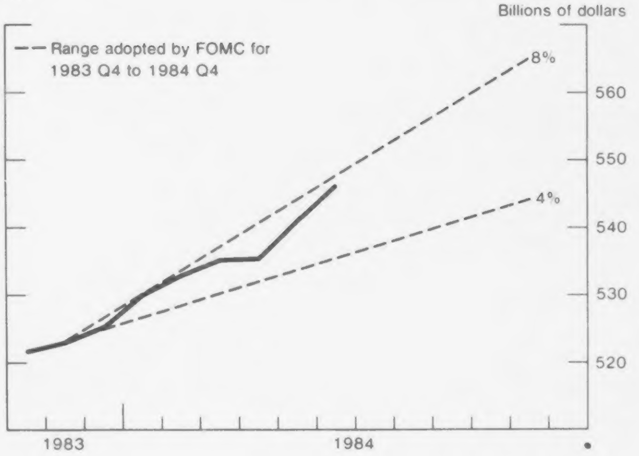
The federal funds rate rose from about 9-1/2 percent in the early part of the year to the 10 percent area in early spring and to around 11 percent in June and early July. The Federal Reserve discount rate was raised from 8-1/2 to 9 percent in April. While the rise in the funds rate--which is sensitive to banks' day-to-day demands for reserves relative to supply--in part reflected somewhat greater restraint by the Federal Reserve in provision of reserves through open market operations during the spring, it also reflected the increased willingness of banks to pay more for federal funds as credit demands remained strong, and as other sources of funds became relatively expensive.

The loss of confidence in the Continental Illinois Bank and well-publicized problems related to ongoing international debt negotiations in May led to a widening in the spread of yields on certificates of deposit issued by depository institutions over Treasury securities of similar maturity. Indeed, investors seemed to show an increase in preference for government securities relative to private credit instruments generally. More recently, yield spreads have narrowed, as progress has been made in debt questions and the Continental Illinois situation has remained unique and contained.

M1 has grown generally in the upper half of the 4 to 8 percent range adopted by the Committee. From the fourth quarter of 1983 through June of this year, that aggregate grew at a 7-1/2 percent annual rate, close to the rate of growth during the second half of 1983, but significantly lower than during 1983 as a whole. Growth in currency, demand deposits, and travelers checks (essentially the narrow measure of money used before 1980) has remained near last year's 5-1/4 percent pace. However, other checkable deposits (OCDs) have decelerated sharply from the nearly 30 percent rate of growth of 1983 to around 14 percent this year. OCDs--primarily consisting of NOW accounts--are interest-earning, and tend to be used not only for transactions but also as a repository for liquid savings. This year's slowing apparently reflects a waning of the motives that led to heavy demands for liquid assets in 1982 and 1983, as well as recent increases in the opportunity cost of holding such balances as interest rates on other instruments have risen.

Ranges and Actual Money Growth

M1

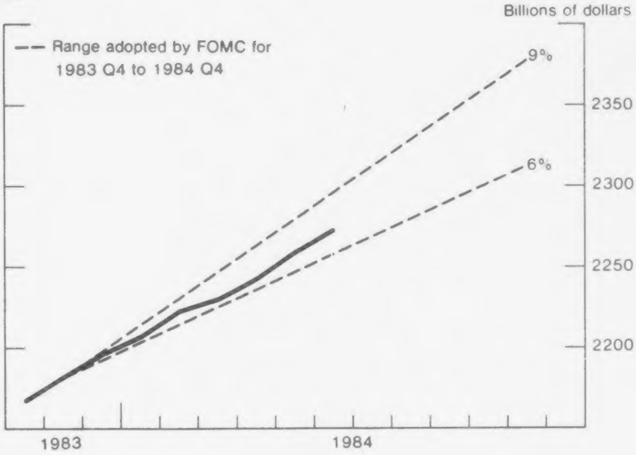


Annual rates of growth

1983 Q4 to 1984 Q2
6.7 percent

1983 Q4 to June 1984
7.5 percent

M2



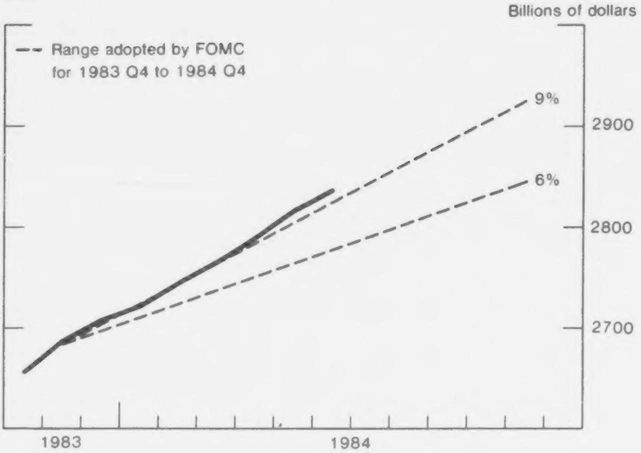
Annual rates of growth

1983 Q4 to 1984 Q2
6.9 percent

1983 Q4 to June 1984
7.0 percent

Ranges and Actual Money and Debt Growth

M3

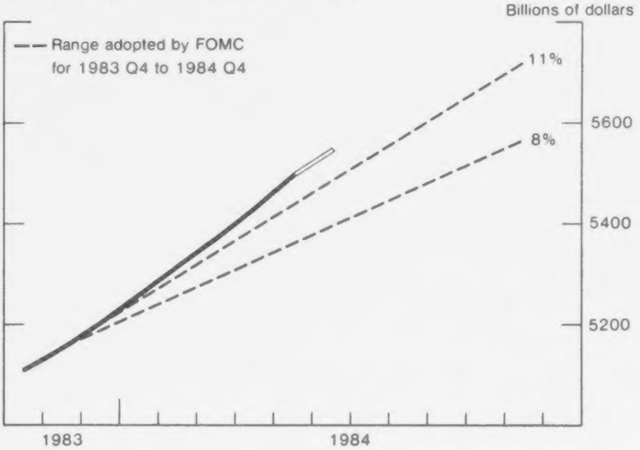


Annual rates of growth

1983 Q4 to 1984 Q2
9.7 percent

1983 Q4 to June 1984
9.7 percent

Domestic Nonfinancial Sector Debt



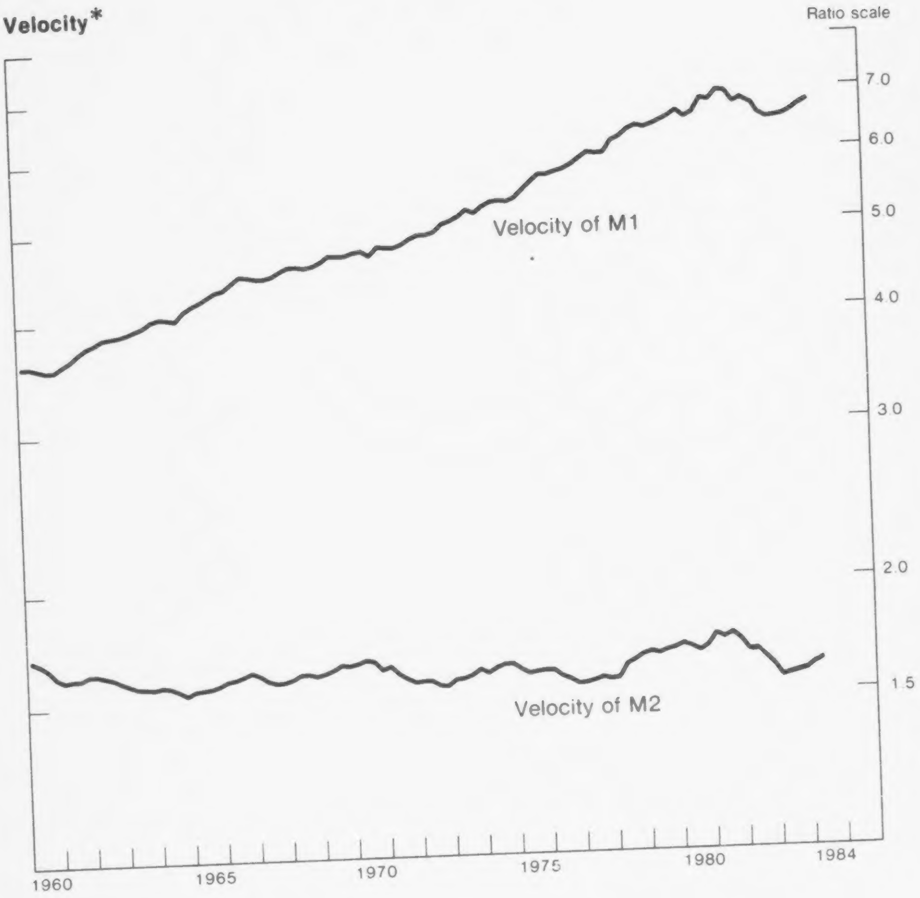
Annual rates of growth

1983 Q4 to 1984 Q2
13.1 percent
(estimated)

1983 Q4 to June 1984
13.1 percent
(estimated)

While M1 growth has slowed relative to last year, its income velocity--measured by the ratio of gross national product to money--increased rapidly, given the strength of the economy and associated demands for money and credit. Over the first half of the year the income velocity of M1 has increased at about a 5-1/2 percent annual rate, a little more rapid than usually has occurred in the second year of an expansion. Nonetheless, the level of M1 velocity still remains about 3 percent below the peak reached during 1981, and about 10 percent below an extrapolation of its pre-1982 trend--suggesting that at least some relatively permanent, sizable increase in demand for M1 may have stemmed from the impact on the public's money preferences of the sharp drop of market interest rates in 1982 as inflation abated, given the comparatively low opportunity cost of holding M1 that developed with the larger role of interest-bearing transactions accounts in that aggregate.

Growth in M2 also has been well below that of GNP over the first half of 1984. To some degree, expansion in M2 appears to have been restrained by heavy inflows to individual retirement accounts (IRAs) and Keogh accounts, which are excluded from money stock measures. Inflows to IRA and Keogh accounts at depository institutions alone surged by more than $20 billion over the first half of the year, much of which likely is not yet taken into account by seasonal adjustment factors. The composition of growth in the nontransactions component of M2 has tended in recent months to shift toward small time deposits, perhaps reflecting a willingness of investors to sacrifice liquidity in order to receive higher yield. At the same time, the fact that depository institutions have lagged in raising their offering rates on time



*Velocity equals GNP divided by M1 or M2 deposits relative to market interest rates probably has encouraged some savers to invest in market instruments instead.

However, M3 growth--like growth in total debt--has pushed above the upper end of its range. This aggregate comprises, in addition to all of the assets in M2, large CDs and certain other borrowings by depository institutions. Thrift institutions have continued to issue large CDs at a rapid pace, owing to heavy acquisitions of mortgages and mortgage-backed securities and moderate core deposit growth. Loan growth at commercial banks strengthened further in the first half of 1984. Commercial banks, which last year ran off about $40 billion of large CDs in response to the flood of money market deposit account money and sluggish loan demand, increased outstandings by $25 billion in the first six months of the year to fund the surge in loan demand. Growth in M3 would probably have been even more rapid had not commercial banks supplemented deposit funds by heavy borrowing from foreign offices, amounting to $15 billion over the first half of 1984.

In general, the rapid further expansion of the economy in the first half of 1984 has been financed by an accelerated rise in velocity of money and by large-scale extensions of credit, all accompanied by further increases in interest rates and by an unusually large share of credit raised from abroad. In the process, greater stresses, or their potential, have been evident this year in the financial position of some economic sectors.

Depository institutions as a group have not been under pressure from disintermediation as they often have in the past when interest rates rose, as regulatory ceilings on yields payable by depository institutions have largely been removed. Thus, deposit flows have been well maintained. Still the profits of banks and thrifts deteriorated in the first half of 1984--in the case of banks partly because of continuing problem loans, and, in the case of thrifts, mainly because of rising interest rates.

With regard to the corporate business sector, the reduction in equity shares outstanding thus far this year, together with the concentration of overall borrowing in short-term market sectors, has in some degree reversed the progress made last year toward stronger balance sheet positions. In the household sector, rapid growth in consumer credit and in mortgage debt, especially adjustable rate mortgages, has increased the actual and potential share of income devoted to debt service.

There has been a sharp upswing in use of adjustable-rate mortgages, most of which are made at initial rates well below the cost of fixed-rate financing, that has tended to support housing activity and mortgage lending. Nearly two-thirds of conventional mortgages originated by savings and loan institutions in early 1984 were of the adjustable-rate variety. Thrifts also have been originating and holding a growing volume of consumer loans. Both of these types of assets carry yields that more closely track current market yields than do long-term fixed rate mortgages. Despite the shift away from origination of fixed-rate mortgages, however, the asset stocks of thrift institutions remain heavily concentrated in such instruments, leaving industry earnings vulnerable to rising interest rates.

The foreign exchange value of the dollar on a trade-weighted basis declined somewhat during the first few months of the year, but since has retraced all of its decline and more, establishing bilateral record highs against several currencies. The dollar's rebound appears partly related to increases in dollar interest rates relative to yields on assets denominated in foreign currencies. Demand for the dollar may have been spurred also by the favorable inflation performance in the United States and a perception that monetary policy will continue to resist inflationary pressures. In addition, part of the dollar's strength may reflect labor relations problems that have affected European currencies, as well as military conflicts in the Mideast. Reports of a widening trade deficit may have weakened the dollar, but on balance the forces mentioned above more than offset the effects of the deficit.

The large net inflow of funds that foreigners have been willing to place in the United States has been an important factor enabling credit markets to finance the faster rise in private borrowing needs, while still accommodating to the unusually large and continuing federal credit demands. Thus, the imbalance, at current interest rates, between domestic savings and domestic demands on that saving from the federal budgetary deficit and private spending for investment has been accommodated by a large further rise in debt owed to foreigners.

The CHAIRMAN. Thank you very much, Mr. Chairman.

As you well know, over the past several years I have shared your concerns about the deficits and we have talked about those over and over again and their impact on the economy, on credit markets, and I still share those concerns and certainly hope that Congress means what they say when they talk about coming back after the election and taking much stronger actions than the so-called downpayment.

STRENGTH OF THE ECONOMY

On the other hand, though, I continue to be surprised at the strength of the economy. Certainly it has grown much more rapidly with less inflation than I anticipated 1 year ago or 6 months ago, and I think that is true of most economists.

The Commerce Department figures show an annual growth rate of 7.5 percent in the second quarter after having grown 10.1 percent in the first quarter. Commerce also announced that inflation in the economy fell to 3.2 percent annual rate in the second quarter from 4.4 percent in the first quarter. Yesterday it announced that consumer prices rose at an annual rate of only 2.4 percent in June.

The New York Times reported that economists say the economy is growing faster with less inflation than it has in two decades and also the New York Times noted yesterday that for the last 18 months the boom in capital investment has been the strongest since World War II. The Times went on to say that economists attribute much of that capital spending boom to the tax cuts of 1981.

Your statement today notes that this recovery and expansion period has been atypical in the sense that such a rapid expansion has been maintained longer after the recession trough than any comparable cyclical period since World War II, excepting only the Korean war period of time.

Would you agree with these economists that the tax cuts of 1981 at least deserve a good portion of the credit for the ongoing boom in capital investment and the strength and duration of the recovery and expansion?

Mr. VOLCKER. I think the tax cuts provided incentives for business investment. High interest rates theoretically work in the opposite direction, but we see a rapid expansion in business investment. Business investment level is still not exceptionally high relative to the GNP, but the rate of growth has indeed been very rapid.

Let me say that I think there has probably been, in terms of what most economists expected earlier and in terms of your own expectations, more thrust from the budget deficit as well as from the particular tax measures than was anticipated; the other side of that coin, on the inflation front, has been, in part, that the competitive pressures related to our foreign trade position have been strong and salutory in the immediate sense.

The dollar has been strong. Goods are readily available from abroad. That has been a powerful competitive force.

I think as we look ahead and against the background of those very favorable developments, we have to ask ourselves, of course, what we need to do to keep the process going effectively at a sustainable rate and to keep that price situation under control. There is a source for concern, because I do think that some policy adjustments are necessary.

The CHAIRMAN. Again, I stated that I agree with you. I share those concerns. But every time we come back we express those concerns again. I guess what I'm trying to get at is why? Why does it continue to grow at this rate with such low levels of inflation, continuing reducing unemployment? In other words, the question I'm getting to, we continue to talk about this and, again, I haven't changed my mind on the impact of the deficits and what they can do in the future, but 6 months from now, we are going to come back here again and we're going to talk about our concerns with the economy still booming, inflation is still down and so on, and why? Why, Mr. Chairman? Are we all wrong in our projections?

Mr. VOLCKER. I don't think we can repeal economics. I do think the inflation situation—I'm repeating myself now—has benefited greatly from the foreign trade situation and the dollar. But you have to ask yourself: Is that sustainable? Is it sustainable for us to supplement our domestic savings by one-quarter from abroad? We are becoming a debtor country. We are borrowing abroad at the rate of $80 billion and $90 billion a year. Is that possible? That is related to that budget deficit that concerns you and concerns me. We are directly or indirectly financing the budget deficit from abroad. That's something you can do for a year or two; I don't know how long you can do it, but I'm certain you can't do it forever, so we've got to make that adjustment.

SOME WARNING SIGNALS FLASHING

The risk in the inflation outlook is frankly what happens to the dollar. We have had an appreciating dollar during this period. We also have a widening trade deficit. Are those things consistent over a period of time? I think warning signals are clearly flashing in that area.

Then, finally, I don't think you referred to interest rates that are on a lot of people's minds. Interest rates have risen somewhat during this period. They started at a very high level. That produces strains and distortions and imbalances both in our economy and throughout the world, and I think that's not something to be taken lightly. You have to ask what's the source of these interest rate pressures. And given everything else that's happening—including what analysis of monetary policy you want to make and the growth in money and the growth in credit, which doesn't seem to me to be starving the economy in and of itself—you have to look at what is causing those high-interest rates and what kinds of strains and distortions that's creating in the economy. Again, I think you come back to legitimatizing your concern and your continuing concern about the deficit.

The CHAIRMAN. Mr. Chairman, I don't disagree with what you said. I guess the only shade of difference we would have is that I would attribute a great deal more of the growth and continuing strong economy to the tax cuts. If we start looking at the level of taxation compared to even financing World War II, we are still being taxed at a very, very high level of gross national product, and there is a difference in how you achieve budget deficit reductions. There is a big difference between whether you take more money out of the economy. If you've got a $200 billion deficit and you decide that you're going to reduce it by $50 billion with $50 billion in tax increases you have reduced the amount of interest paid on that deficit, but you're still removing $200 billion from the private sector, $150 billion from the borrowing and $50 billion more from taxation; compared to reducing it by expenditure reductions by $50 billion, you're only taking $150 billion out of the private sector and removing pressure from those credit markets for higher interest rates.

So I think the tax cuts are very, very helpful. If I had my way, which I obviously don't, I would go for additional tax reductions with expenditure reductions, rather than continuing to talk in a political year about who's going to raise taxes after the election. I think it's a bad way to go, the wrong way to go, in the economy we have been describing with either party or whoever gets elected, rather than talking about expenditure reductions.

According to data from the St. Louis Federal Reserve Bank, growth in the adjusted monetary base has been highly erratic in recent months. The March 14–May 23 adjusted base declined at an annual rate of 4.7 percent. From May 23–July 18 the base grew at a 20-percent rate. The monetary base is the aggregate over which the Federal Reserve has the most direct control.

Why has the growth been so erratic? Doesn't this lead to uncertainty in financial markets that put upward pressure on interest rates?

Mr. VOLCKER. I should say first of all, I don't look at the St. Louis calculation of the monetary base which has some conceptual questions attached to it. The monetary base is what we directly influence, but we influence that for other purposes. We don't aim, in the first instance, at creating stability in the monetary base itself. What we are interested in is what effects that has on the monetary aggregates that we do target and, in turn, judging those in the context of overall economic activity.

Bank reserves have been moving quite erratically recently, and they are a component, the most volatile component in the monetary base, however it's calculated, partly because of variations in behavior of banks with respect to holding excess reserves that have been influenced by a variety of uncertainties in financial markets. We have had periods of several weeks where excess reserves have moved quite erratically judged against any trend when the money supply has not. We're interested in the money supply.

I think for quite a while currency, which is the biggest component of the monetary base, has shown some odd fluctuations, too. We do not attempt, for perhaps obvious reasons, to control the amount of currency in circulation specifically, but it's very heavily weighted in the monetary base.

The CHAIRMAN. Thank you, Mr. Chairman. My time is up.

Senator Proxmire.

CAUTION AND CONSTRAINT NEEDED

Senator PROXMIRE. Chairman Volcker, in my opening statement I said that the economy's rapid growth suggested this seems to be a time when monetary policy should be cautious and constrained. Would you agree with that?

Mr. VOLCKER. Yes.

Senator PROXMIRE. Now Treasury Under Secretary Beryl Sprinkle told this committee a few months ago that any policy changes by the Fed with respect to monetary aggregates would affect inflation with a 2-year lag. He presented an elaborate graph that showed a remarkable consistency between changes in M1 and the rate of inflation with a consistent 2-year lag.

If that's true for inflation, it seems to me that the consequence of monetary policy changes on unemployment would also have a very long lag. Since inflation and unemployment are the two big political enchiladas, since the election is less than 3½ months away, is there any economic role of the Fed in the coming election? With the economic powerhouse agency you have, are you all finished as far as contributions you could make to the outcome of the 1984 congressional and Presidential elections?

Mr. VOLCKER. If you assume some lags, I think that's correct.

Senator PROXMIRE. Are the lags right?

Mr. VOLCKER. I think there are long and variable lags. That's the whole problem with monetary policy and other economic policy measures. If there were no lags, if we could move today and affect everything tomorrow in some predictable way, you could have an automaton run the Federal Reserve. I don't think that is the experience and I do not share the confidence of some that these lags—for instance, the 2-year lag that you mentioned from monetary growth to prices—is nearly as consistent in the historical record as we would like to have it.

Senator PROXMIRE. Let me ask you this. Is there any economic indices—say, interest rates—which could be affected by the Federal Reserve policy now or next month that would have an effect before the November election?

Mr. VOLCKER. If very strong actions were taken one way or another, I'm sure, yes. You will recall the episode—this wasn't exactly monetary policy in the ordinary sense—in early 1980 when the decision was made to adopt some relatively mild controls on consumer credit, and the psychological reaction was such that the economy almost instantaneously reacted, contrary to everyone's expectations. Now that, I think, was almost entirely because of the psychological impact of a measure announced by the President.

Senator PROXMIRE. That psychological reaction is very tricky, isn't it?

Mr. VOLCKER. Yes.

Senator PROXMIRE. In other words, if you follow a policy of trying to hold down interest rates as some have suggested by increasing M1, the investors may interpret that as inflationary and therefore interest rates may rise?

Mr. VOLCKER. Yes, I agree with that.

Senator PROXMIRE. On page 8 you have told us that:

Viewed in a medium-term or longer perspective, those growth rates for M3 and domestic credit are higher than consistent with sustainable rates of growth in the economy and progress toward price stability.

In other words, you are telling us that that growth is inflationary and for that reason you say the Committee decided not to raise the target ranges for this year.

Well, can't you do more than that? Are there any policies you can follow that would reduce the rate of growth in M3 so that it would be more sustainable and less inflationary?

Mr. VOLCKER. Presumably, yes, if we put more pressure on bank reserve positions and in that sense had a more restraining policy, over time the growth in M3 and debt would be reduced. We would also have a reduced growth in M1 and M2, maybe more promptly than in the others.

Senator PROXMIRE. Why shouldn't you do that then?

Mr. VOLCKER. This is what you have to reach a judgment on and that has been debated.

Senator PROXMIRE. But you decided not to change M1 and M2.

Mr. VOLCKER. We decided, looking at everything that's going on, including M1 and M2 which are within their ranges—in fact, M2, I think, is at or below the midpoint of the range while M1 is relatively high in its range—and looking at the rest of the economy and looking at indications of price pressures and looking at conditions in financial markets, we did not take, as I reported, additional restraining measures. Interest rates have continued to go up during most of this period, except for the last couple of weeks, when there's been a lot of volatility.

Senator PROXMIRE. Now there's been a lot of criticism of Jesse Jackson for what he did in Cuba and in Nicaragua, but he's not under the discipline of the administration or of the executive branch. Recently, the U.S. Ambassador to France held a press conference in Paris where he declared that the Federal Reserve should reduce short-term interest rates. The purpose of the press conference apparently was to affect monetary policy.

I wonder if you have any comment on the state of our diplomatic relations with France and how we could improve them?

Mr. VOLCKER. No, sir. I found the source of those comments a little odd in terms of history, and I must say I found the analysis a little curious as I looked at it.

Senator PROXMIRE. I have never seen that happen before. It seems to me if we have any diplomat who is qualified to make this kind of judgment it would be Arthur Burns, our Ambassador to Germany, who is eminently qualified but who has the sense not to butt in.

NOMINATION OF DR. SEGER

On July 2, the President nominated Martha Seger to the Board of Governors. I felt this was extraordinary. It was extraordinary because this was a very controversial appointment. Martha Seger was opposed by every Democrat on the committee. The nomination now comes to the floor. I didn't see that it was an emergency kind of situation. Perhaps it was, but that case hasn't been made.

Did you ask the President for a recess appointment?

Mr. VOLCKER. No.

Senator PROXMIRE. Were you consulted on the President's decision to make a recess appointment?

Mr. VOLCKER. No.

Senator PROXMIRE. Is there any evidence that the Board or the Open Market Committee would have difficulty performing their responsibilities had they waited for Dr. Seger to be confirmed through the normal processes of the Senate?

Mr. VOLCKER. Not from my particular point of view, but I suppose other opinions may differ on that.

Senator PROXMIRE. Why do you suppose the President used his recess appointment authority in this case?

Mr. VOLCKER. I don't know.

Senator PROXMIRE. I understand the Secretary of the Treasury was consulted on Dr. Seger's initial nomination. I understand Dr. Seger was interviewed at some length by the Vice Chairman of the Federal Reserve Board, Mr. Martin. Were you involved in this selection?

Mr. VOLCKER. Yes; I was aware of the process and had opportunities to comment upon it, but this appointment process is the President's and the Congress.

Senator PROXMIRE. Are you aware of any other controversial appointment to the Federal Reserve Board that's ever been made on a recess basis? It seems to me that this agency is so importantly independent of the executive branch that to have this appointment made under these circumstances is an extraordinary precedent and I think perhaps a dangerous precedent.

Mr. VOLCKER. I don't recall any, Senator, of this kind.

Senator PROXMIRE. Now, some people argue that the Reagan administration seems to have shifted from Fed bashing to big bank bashing in their effort to explain why interest rates remain so high. Are banks responsible for keeping interest rates artificially high?

Mr. VOLCKER. Are bankers responsible?

Senator PROXMIRE. Yes, sir.

Mr. VOLCKER. I would not describe bankers as responsible for keeping interest rates artificially high. As I indicated in my statement, in this deregulated banking environment, a period of economic expansion particularly, I think there is a sense among bankers that they don't have constraints on their ability to raise money. To overstate it a bit, you make the loan and then you finance it, and as credit expansion proceeds. It does have to be financed; the bidding for funds proceeds, and that raises rates in the market. That's the way the market process works.

I wouldn't call it exactly artificial. I wouldn't call it artificial at all. My concern about the process would be whether, in the end, from the perspective of the entire economy, the credit expansion doesn't proceed faster than is healthy in aggregate terms, which we have to look at in terms of our policy, but also importantly in terms of individual banks retaining appropriate prudence in their lending process.

Senator PROXMIRE. Now let me move quickly to another subject. My time is almost up.

LOWER INTEREST RATES FOR FARMERS

Senator Exon, a Senator whom I especially admire and like, is a neighbor right across the street and a good friend, has introduced a resolution. You referred to the same concern that he had on page 5 of your statement when you talked about the effect of high interest rates on farmers. His resolution, S. 130, expresses the sense of the Senate that the President should cooperate with the Fed to exercise appropriate authority to ensure that an adequate flow of credit is available to American farmers at reasonable rates and that American farmers be treated not less favorably than foreign borrowers with comparable levels of risk.

What about this? Is there anything the Fed can do to lower interest rates paid by farmers? As you know, they are in terrible straits. Prices are down now. Foreclosures are very common. It's almost a depression that many people aren't aware of because they now constitute a relatively small percent of the population, but it's a real crisis out there.

Mr. **Volcker**. There's no question that there are strong financial strains on farmers who are at all heavily indebted, and many of them are, as you know. I think there are real problems out there created by the general interest rate situation. I think our ability to deal with that on a selective basis is extremely limited. It's basically nil.

My concern about resolutions of that type are that they imply that we have got more power than we do to deal with the situation. What we have tried to do, as I indicated in my statement, is something which I suppose is broadly analogous to the kind of comments we made about the international debt situation. In the case of farmers who are in a position, basically, where over time they should be creditworthy, but are in a debt squeeze right now and can't keep up with their payments, and when the bank appropriately thinks that forebearance ought to be shown, we have said we don't want the bank examiners classifying those loans when they also have the judgment that that farmer can be basically creditworthy. We try to make sure that the appropriate reaction of a banker in being tolerant, understanding, and forebearing in these situations is not discouraged by the bank examiners, and I think we have done that.

Senator **Proxmire**. Thank you, Mr. Chairman. My time is up.

The **Chairman**. Before I turn to Senator Mattingly, I would just respond to the Senator from Wisconsin and the Chairman that Mr. Eccles was a recess appointment, for whatever that is worth, and I can't say that from personal knowledge because that was so long ago that I was in a period when I had no hair. In between I had hair. I have gone from that period through the hair period and back to the bald state where I was a 1 year old when Mr. Eccles was a recess appointment to the Fed.

Senator **Proxmire**. If the chairman would yield on that, I think bald states are controversial and I've tried to do my best to improve my status. But Mr. Eccles was not a controversial appointment. I don't know of any Senators who were against him.

Mr. **Volcker**. My counsel has given me the same note that Mr. Eccles' first appointment was made during recess.

The CHAIRMAN. At my age at that time I don't know whether it was controversial or uncontroversial and I can't afford the kind of surgeon that Senator Proxmire had.

Senator RIEGLE. Mr. Chairman, just for the record, I wonder if the same historian is here to tell us whether that occurred in the midst of the session or at the end of the session.

Mr. VOLCKER. We will provide the circumstances for the record, Senator.

Senator RIEGLE. I would be very surprised if it occurred in the midst of the session.

Mr. VOLCKER. Let us research the issue and provide the answer for the committee.

The CHAIRMAN. I'm not sure that it's too important one way or another.

Mr. VOLCKER. Somebody else had a very temporary appointment, but I will provide the circumstances to you for the record. I was 8 years old at that time.

The CHAIRMAN. Senator Mattingly.

[The information was supplied for the record:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

August 6,1984

The Honorable Jake Garn
Chairman
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

During the Committee's hearing on the conduct of monetary policy on July 25, 1984, Senator Proxmire raised the question of whether there had been any recess appointments of Federal Reserve Board Governors by Presidents prior to the recess appointment of Governor Seger. During the subsequent discussion, you pointed out that Chairman Eccles had received a recess appointment, and Senator Riegle requested information on whether there were any other recess appointments and whether any of those appointments had been made prior to the adjournment of the Senate *sine die*. I said that I would supply the information for the record.

The enclosed memorandum notes that there have been three recess appointments made to the Board: Adolph C. Miller on August 21, 1934; Marriner S. Eccles on November 15, 1934; and John E. Sheehan on December 23, 1971. The Miller and Eccles appointments were made after the adjournment *sine die* of the First Session of the 73rd Congress and the Sheehan appointment was made after the adjournment *sine die* of the First Session of the 92nd Congress.

With best wishes.

Sincerely,

Paul A Volcker

Enclosure

cc: Senator Proxmire
Senator Riegle

August 6, 1984

MEMORANDUM

SUBJECT: Previous Recess Appointments to the Board

Prior to Governor Seger's appointment to the Board of Governors, there had been three recess appointments made to the Board: Adolph C. Miller, on August 21, 1934; Marriner S. Eccles, on November 15, 1934; and John E. Sheehan, on December 23, 1971.

All three of the previous appointments were made when Congress had adjourned *sine die* between sessions. Both Mr. Miller and Mr. Eccles were appointed during the adjournment between the 73rd Congress and the 74th Congress, which lasted from June 18, 1934 to January 3, 1935. Mr. Sheehan was appointed during the intersession recess from December 17, 1971 to January 18, 1972, between the first and second session of the 92nd Congress. In all three cases, the nominations were *first* submitted to the Senate *after* it reconvened from the recess during which the appointments were made.

The relevant dates for each appointment were as follows:

Adolph C. Miller[1]

Adjournment of Senate (73rd Cong.)	June 18, 1934
Recess Appointment	August 21, 1934
Oath of Office	August 21, 1934
Senate Reconvenes (74th Cong.)	January 3, 1935
Nomination Submitted to Senate	January 10, 1935
Favorable Report from Committee	January 22, 1935
Confirmation by Senate	January 23, 1935
Permanent Appointment	January 26, 1935
Oath of Office	February 1, 1935

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[1] Mr. Miller was one of the original members of the Board. He was first appointed in 1914 and reappointed in 1924.

Marriner S. Eccles

Adjournment of Senate (73rd Cong.)	June 18, 1934
Recess Appointment	November 10, 1934
Oath of Office	November 15, 1934
Senate Reconvenes (74th Cong.)	January 3, 1935
Nomination Submitted to Senate	January 10, 1935
Hearings Before Committee	April 15 and 19, 1935
Favorable Report from Committee	April 23, 1935
Confirmation by Senate	April 24, 1935
Permanent Appointment	April 25, 1935
Oath of Office	April 27, 1935

John E. Sheehan

Adjournment of Senate (1st Sess., 92nd Cong.)	December 17, 1971
Recess Appointment	December 23, 1971
Oath of Office	January 4, 1972
Senate Reconvenes(2d Sess., 92nd Cong.)	January 18, 1972
Nomination Submitted to Senate	January 24, 1972
Hearings Before Committee	January 27, 1972
Favorable Report from Committee	January 27, 1972
Confirmation by Senate	February 7, 1972
Permanent Appointment	February 7, 1972
Oath of Office	February 8, 1972

Senator **Mattingly**. Thank you, Mr. Chairman. I'm not sure whether anybody who's got to borrow money in the private sector is too worried about that appointment.

We now go to the haired members of the committee to ask questions. I thought I'd throw that in. [Laughter.]

Let's return to the original question of Senator Garn. I think he was trying to get you to say you were supporting the President's policies. On page 5, you made the comment that it is in the end a choice between building on the enormous progress of the past to achieve sustained growth in a framework of greater stability—I assume you're endorsing the Reagan policies of the last 3½ years—"or a relapse into inflationary economic malaise," which sounds like the 4 years of the Carter administration.

In order to treat all us dogs equally, are you saying that the policies of the last 3½ years——

NO POLITICAL COMMENT

Mr. **Volcker**. I am making no political comment whatsoever. I am somewhat aware that this is the period for debating these issues, but I don't want to entertain debate in that context.

Senator **Mattingly**. Well, are you saying the policies—taking the candidates out—the policies of the last 3½ years have made a lot of economic progress?

Mr. **Volcker**. I have said this repeatedly—and I recall saying it 18 months ago in my comparable statement—that I thought we had succeeded in laying the foundation for the possibility of a long period of sustained growth with greater stability, and I think those things have to go together. Indeed, I think a lot of what's going on has been very favorable, not only in the immediate sense but also reflecting changes in attitudes, changes in behavior, changes reflected in restraint on pricing, restraint on wages, high productivity, signs of increased business investment; that all augurs very well. But there are some very real shoals out there that simply must be dealt with and, indeed, the events of the economy make it more urgent to deal with them.

Senator **Mattingly**. But the policies of 1979 and 1980 in that era which gave us 21 percent prime and 13 percent inflation, and the policies that we have now——

Mr. **Volcker**. Maybe I'd better just say that I was here in 1979 and 1980, so as far as the Federal Reserve was concerned, I would like to think those policies were part of laying a sound base, too.

Senator **Mattingly**. Right. But generally speaking, you think the tax cuts and the reductions in Federal spending is healthy for our economy?

Mr. **Volcker**. I'm not sure I have any difference at all with Senator Garn. I said—the words may sound familiar to you because I repeated them in earlier testimony—that clearly the ratio of Federal spending to GNP is above historical relationships; taxes are about as high as they have ever been relative to the GNP. From a strictly economic point of view, I believe that the more that spending can be reduced to close this gap, the better.

I have also said that, as a practical matter—and that's what the political process is all about—if it can't be done on the spending side, you've got to look at the revenue side.

Senator **Mattingly**. You're still recommending spending cuts first?

Mr. Volcker. The more you can do on spending, the better.

Senator Mattingly. Right. You're still endorsing spending cuts first?

Mr. Volcker. Right.

Senator Mattingly. Thank you. I guess we've come a long way in 3½ years.

FED'S MONETARY TARGETING

It's been reported that the views of a number of analysts feel that money supply targeting has always been a secondary objective of the Federal Reserve to interest rate manipulation. The implication is that monetary stability will be abandoned whenever the Federal Open Market Committee feels that interest rates should be higher or lower.

How would you respond to that?

Mr. Volcker. I think the monetary targeting is designed to and does give us a substantial element of discipline, and it's a kind of point of departure in assessing policy. It's a strong point of departure; there's a strong presumption we'll follow these targets.

If you ask me whether there are particular situations when you would follow a target and not take account of judgments about whether the relationship between money and other forms of economic activity were changing, we obviously do use an element of judgment. You will recall that in the second half of 1982, for instance, where we thought some of the monetary numbers were giving misleading signals, when we assessed the overall economic situation, we permitted monetary growth to exceed the targets, particularly M1 growth. But that was done on the basis of a general analysis and not done in an effort to seek a particular level of interest rates, which I think would be a mistake; we are not doing that.

As you know, interest rates have gone up somewhat in recent months when the money supply has been rather equitable.

Senator Mattingly. Suppose that the Federal Reserve revealed the nature of its policy decisions shortly after they were formulated. What effect would this have on the markets? Wouldn't the public be able to make more efficient decisions regarding employment, savings, investment, production, and consumption?

Mr. Volcker. No. I think the opposite actually, Senator. Some decisions clearly can be announced that would have no impact at all. You announce we're not doing anything different, say. When we change the discount rate, we do announce that. But many of our decisions are conditional by their nature. The Committee meets at intervals and decides what to do today and what to do some weeks later if something else happens.

Let me give you one example of that, one rather clear example. In December, the Committee reached a decision and said in effect—and this has long since been published—that we don't want to do anything at the moment, but we really are directing the open market desk in New York, the operating arm, to tighten up a bit if the money supply shows signs of rising more rapidly than we now expect or if certain things happen in the economy.

Those things never happened and there wasn't any additional restraint put on the economy at that time. But if we had announced that at the time of the meeting, the market would have reacted, I assure you. I can almost guarantee that because the market reacted a little bit a month later when we announced the decision, even though by that time it was no longer applicable. The market always wants to know, and the real problem is not what we did yesterday or what we are doing today, but that they want to know what we're going to do tomorrow or next month, and that's an unanswerable question in its details.

Senator MATTINGLY. But I think a lot of people feel the public would just spend a lot less time and money trying to discover the intent of the policy if they knew what the decisions were immediately.

Mr. VOLCKER. There's a debate on this subject and all I can give you is my strong feeling, based upon 20 or 30 years of experience in this business, that it would make things worse.

Senator MATTINGLY. We won't pursue that any further. I do have a bill, Senate bill 2620, which is the Federal Reserve Reform Act, which I'm sure you're familiar with, to require such disclosures. We will debate that at a later time because I think, as you well know, that there is a need for greater disclosure.

Mr. VOLCKER. I know people come to differing views. All I can tell you is that, based upon all my experience in this business, I think it would turn out to be a mistake.

Senator MATTINGLY. I think there are parts of that legislation that you would agree with now from some of your testimony.

Mr. VOLCKER. If I may just say one further word on this, I think we should make a distinction between policy and implementing policy. We're discussing policy here today in terms of these targets and the background for them. These decisions about precisely when you increase pressure on bank reserves are all within the context of an announced policy. If the policy changes, I agree that we should announce it. What the argument is about, in my terms, is whether you announce all the implementing decisions.

STRETCHOUT OF INTERNATIONAL LOANS

Senator MATTINGLY. One last question. With reference to the international loans which you spoke about. Recent financial publications continue to report that a lot of the major banks are writing down many of those international loans because they are of questionable quality. At some point in the future these institutions are going to have to face reality and stretch out these loans if they ever hope to be paid.

Do you, as a regulator, currently have the authority to require such a stretchout of those loans?

Mr. VOLCKER. We don't have any regulatory authority to require a stretchout. We do have authority to——

Senator MATTINGLY. Does current authority allow you to require such action?

Mr. VOLCKER. No.

Senator MATTINGLY. Would you like such authority?

Mr. **Volcker**. I don't think I want to get into the banking business to that degree. I express opinions about it publicly. In that sense, we get involved in the process. The International Lending Supervision Act last year had specific words of congressional endorsement of that approach, but it's not a specific regulatory authority that we have.

Senator **Mattingly**. But you and I agree that a lot of those loans can't be repaid in that timespan that they've currently scheduled.

Mr. **Volcker**. That is correct. I think the bankers understand that, too.

Senator **Mattingly**. Right. But the banks have got to take such action voluntarily or else somebody is going to have to require it of them.

Mr. **Volcker**. You get into obvious negotiating arguments. If you take the other side for the moment, they say, "That's right; we've got to look toward repayment over a longer period of time, but I'd rather make that decision about just how long and what the interest rate is when the loan comes due rather than in advance." That's got the disadvantage of leaving a great deal of uncertainty surrounding the situation, but it can be argued that this is the way of maintaining discipline on the borrower.

I think there are legitimate matters of banking practice that are involved here, but I do think it is important—to repeat what I already said in my statement—that where countries are making real progress, and they've taken very tough measures, and their external position is improving but they clearly can't repay the pileup of short-term debt, there may be a mutual interest in stabilizing the situation and stabilizing the psychology by providing now for a more orderly repayment schedule.

Senator **Mattingly**. My time is up. I'm glad you agree with me that some of these loans will need to be stretched out. Thank you.

The **Chairman**. Senator Riegle.

Senator **Riegle**. Mr. Chairman, approximately how many banks are on the problem list at the moment?

Mr. **Volcker**. I haven't got that.

Senator **Riegle**. Would any of the staff present have that information? I see the figure at roughly 700. Is that correct?

Mr. **Volcker**. I don't think we have announced such a figure; other agencies may be different. We only directly supervise State member banks. I certainly don't have that information with me.

PROBLEM BANKS RANGE NEAR 700

Senator **Riegle**. Well, let me tell you what I'm reading and I assume you're reading the same things in the financial journals, and that is that there are very substantial numbers of banks on the problem list. The general number that is used today is in the range of 700. In talking with savings and loan people, I find they are increasingly being squeezed into an adverse position. As you well know, more and more of the savings and loans, despite the legislation we passed 3 years ago, are being pushed back into an enlarging problem category, and I assume the same is true for credit unions. This is raising a lot of justifiable apprehension about the overall structural soundness of that sector of the financial system.

Now there's more and more talk about certain areas of the economy that are experiencing a kind of deflation, a relatively new experience. Our main concern has been inflation for a long time, but now, as you know, there are a number of people that are starting to focus on sectors that are witnessing a rather sharp deflation. We're seeing that with respect to the value of farm land, its collateralized behind a lot of loans. We saw it a couple years ago with energy loans which is a major factor in the problems experienced by Penn Square and Continental Illinois. I recognize the fact that the economy is uneven; that there are areas of strength and there are areas of weakness—but how do you view the areas which are now experiencing deflation and what observations could you make about that?

Mr. VOLCKER. Undoubtedly, there are areas that are under heavy pressure, as you indicated. I think you mentioned the two leading sectors within the U.S. economy. When one looks around the world, you've got countries that are under very heavy pressure. The way I would size that up is that I think it has some dangers; it should be addressed. There is too much unevenness and to a considerable degree that unevenness is a reflection of a particular mix of public policies. And I come back to the root of this—not all of it but some of it—which is the fact that we are forced to finance a very large budget deficit at the same time the strong sectors of the economy are borrowing a lot of money and that puts pressure on interest rates and aggravates some of those sectoral strains without question. The whole imbalance in foreign trade is fundamentally related to this, which is perhaps the most serious manifestation of the kind of imbalances that you describe.

I take it extremely seriously and it's another way of stating some of the concerns I talked about in my statement. The relevant question is: How do you deal with that? I think the answer to that is pretty straightforward. We have the tools for dealing with it in a way that's constructive, in a way that deals with that without losing all the gains that Senator Mattingly and others have spoken about here.

EFFECTS OF DEFLATION ON THE FINANCIAL SYSTEM

Senator RIEGLE. I'd like to try to connect the two factors. I'd like to try to connect the unevenness of the economy and the deflationary problem areas to the structural soundness of the financial system, and there are a lot of variables which bring this in focus. Obviously, the problems experienced by Continental Illinois are very much front page news and that stems principally from energy loans but one assumes other factors as well, keeping in mind that we have a long list of other financial institutions which are presently experiencing difficulties as well.

What I'm concerned about is, if you go back to the 1920's, there were really two periods where we began to experience substantial deflation in certain sectors. We were able to weather that deflation in the early and mid-1920's. But when it extended into the late 1920's and early 1930's we found ourselves in a rather rapid deflation because the bottom fell out of a lot of price levels in different sectors, from land, across the board, to other kinds of assets.

The concern I have here is: How much margin have we left in terms of the overall structural soundness of the banking system to be able to take another set of shocks here on the margin?

I talked the other day to the head of a major money center bank who pointed out to me that the agricultural loan problem has now grown to an entirely new dimension for that particular institution, and he expressed a rising level of concern about what is happening in terms of those collateralized farm loans. I thought to myself, this is likely to be one of the next stories that we will be reading about that hasn't really received front page treatment today.

I'm wondering, has the Fed done any analysis yet on the pockets of deflationary pressure, including commodity prices as they would feed back through to additional pressures on the banking structure and the financial structure at this point?

Mr. VOLCKER. We try to evaluate all these things, but if you think that somebody can come to a simple timing of or mathematical answer to just what the problems will be in the agricultural sector next year in this respect and how they might have repercussions on agricultural banks around the country, I think you're asking something that is beyond any analytic capability. I would simply say——

Senator RIEGLE. I'm not trying to just limit it to agriculture. I would include foreign loans and other kinds of loans.

Mr. VOLCKER. The foreign loan situation is as I tried to describe it. I think there are signs of progress in some countries, some important countries, and in some sense fundamental progress is being made, but sentiment has not been very buoyant surrounding that problem recently for perhaps understandable reasons, because there are other countries not making progress, and there is a real concern about these protectionist measures and interest rates. That's as much psychological as real.

I would simply respond to this whole line of inquiry, Senator, by saying if you are concerned about these things—and I recognize that you are; I reflected my degree of concern in my statement—that there is just no reason not to begin to take the measures that will clearly relieve those pressures then these kinds of questions won't arise.

I don't think it's very useful to make a calculation that if this went on for 2 years it's going to be a problem, or if this goes on for 18 months it's going to be a problem, or maybe we can wait another 9 months. Do it now; go ahead.

Senator RIEGLE. Well, I agree on the need for action now and the sense of some considerable need of urgency and in fact you use language in your statement that I thought made it quite clear that you have a genuine sense of concern. On page 2, you say that if we don't act we potentially face severely adverse implications. I think that's pretty blunt language and I agree with it.

But this is what I think we need to do at this point. I think it isn't just the deflation that we're seeing with respect to farm land values and commodity prices and certain other areas that are working their way back through the collateralized loans and just the ability of certain creditors to even pay their bills, but in a broader sense, we have seen a kind of devaluation of the quality of the foreign loans. A lot of them had to be written down in the sense that they're nonperforming. I'm not saying they are exactly the same thing. What I am saying is that the collateral base of a large number of financial institutions in this country is under rather substantial pressure and that's why I asked the question at the outset of how many banks and financial institutions are on the problem list. And the answer is, a very substantial number and the list is growing. It's not receding.

We are about to nationalize one of the biggest money center banks in the country because it just basically failed, and I don't know how many more might be right behind it. I hope no others.

Mr. **Volcker**. I think that situation is unique. But let me point out, in terms of this concern that you're expressing, we have—and perhaps that incident reflects it—a very strong safety net, a very strong apparatus in this country to deal with problems of that sort when they do arise unexpectedly.

Senator **Riegle**. You also mentioned another area that I want to discuss and I hope to do so on the second round. That's your concern about leveraged buyouts. I have a similar concern because what we're seeing is the subtraction of equity and the replacement of it with debt and to a rather substantial degree, and in a sense it seems to me that's applying still a further kind of strain on financial institutions.

So I would hope that the Fed would conduct a study on this. I think the time has come for the Fed to take a look at the question to which the unevenness in the economy is hitting sectors, such as the energy sector which was hit before, that may be causing an aggregate pileup of new strain on financial institutions that may press us out to the outer edge of what our system is capable of handling. I do have an apprehension about it and I'd like you to take a look at it and let us know what you think.

Mr. **Volcker**. We try to take a look at this kind of thing all the time, and I would simply repeat myself by saying if you have this kind of concern I hope you will press for those obvious policies that deal with it——

Senator **Riegle**. I intend to.

Mr. **Volcker** [continuing]. In the only effective way they can be dealt with.

COMPETITION OF BANKS FOR FUNDS

Senator **Riegle**. I just want to conclude by mentioning the ads that are running today in the New York Times which you have probably seen. They began running this week under the headline "Rate Alert." This happens to be an ad for Manufacturers Hanover but Chase Manhattan is running similar ads, where they are now offering for a 6-month certificate an effective annual interest rate of 13.34 percent for any amount over $500. Now this seems to me to be an extremely high rate of interest to be offering at this stage of the game on accounts for a 6-month term that go up from the lowest level of $500.

I'm wondering how are we to make sense out of that? We may conclude that a number of these banks, not just one, but the big money center banks in New York are doing this because they're anticipating higher interest rates in the future so they are willing to commit themselves to pay a higher rate for deposits because they expect rates to go up, but it also makes me wonder if there isn't a kind of churning going on here where they feel the need to bring in immediate deposits for whatever the reasons. Presumably they need them and they are willing to put out their rather high rate of interest in order to meet whatever their immediate cash requirements are. How are we to interpret this?

Mr. VOLCKER. I think you are using today's paper to illustrate a point I made and alluded to generally in my statement, that in this banking environment we have now, during a period of rapid credit expansion—and a lot of that credit expansion has converged on banks—they need the loan demand, may even seek out the loan demand, and then finance themselves by bidding in the market aggressively for money. If the cost of their money goes up as a result, the thought is the interest rate on the loan will go up. You get a kind of ratcheting process—it's a market process—in the midst of a strong economic advance, a strong credit demand. Ten years ago it wouldn't have happened that way, because you had these interest rate ceilings and banks would have been forced to constrain the loans, but we now are living in a different banking environment. You don't get restraint on bank lending any more from an inability to raise money because banks are up against ceiling rates. We have taken off the ceiling rates and this is the market response that you see during a period of this kind.

Senator RIEGLE. I'll conclude with the predicament Continental Illinois now finds itself in. Continental Illinois got into a situation where suddenly its cash requirements were so severe that it had to resort to virtually every expedient, including borrowing institutionally, to meet its overnight reserve requirements, and I'm wondering if there's any suggestion in the case of the big New York money center banks that this sudden ratcheting up in rates is because they need to suddenly increase their reserves to the point of going with extraordinarily high rates to do it.

Mr. VOLCKER. Continental Illinois, after a passage of time, was excluded from the markets because of the confidence problem. But I think banks should be careful about keeping their funding up where they are ahead of their asset growth. The point I'm making is, there isn't any restraint on the asset growth of the kind that there used to be except by the interest rate itself, because the interest rate rises in this process.

Senator RIEGLE. Well, I will come back. My time is up.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman. I just want to make one serious comment before I get to the questions here. I just wanted to ask Chairman Volcker if he kind of agreed with the notion that you and Senator Mattingly touched on earlier, which is that a lack of hair inhibits fuzzy thinking. [Laughter.]

Mr. VOLCKER. No comment.

Senator HEINZ. We'll put you down on the yes column on that.

Senator MATTINGLY. I'll get him on the second round.

Senator HEINZ. Chairman Volcker, in your statement you touched on some of the costs that we are paying as a result of high interest rates and as a result of high deficits and as a result of combined with a lot of borrowing in the private credit markets, and you indicated that the farmers have been particularly hard hit, that thrifts have been hard hit, that those businesses that tend to be undercapitalized, mainly small business, those that don't have as easy access to equity markets have been hard hit, and you sounded some alarm, as I understood your testimony, about what further rises in interest rates would do to less developed countries [LDC] already heavily burdened with debt.

That's a pretty grim scenario in and of itself, but I'm wondering if there's still more to it. Chairman Garn mentioned that capital spending had been healthy, very healthy, but as I recollect from our hearing in June, there are some holes in that capital spending picture that are not as rosy as the superficial analysis of the New York Times would point out. Would you care to elaborate on that?

Mr. VOLCKER. I think you're probably referring to a point that I may have made——

Senator HEINZ. Nothing personal.

Mr. VOLCKER [continuing]. In an earlier hearing. It may be in the process of some change, but investments have been very heavily concentrated on rather short-lived investment, electronics, data processing, computers, and all the rest. There has been less in machinery plant expansion and so forth. I think the most recent evidence suggests that that area is certainly improving as well, but it has lagged behind some of the other forms of business investment, which you could expect with interest rates so high. The high-interest rates are a much greater inhibition on long-term investment than short-term investment.

LONG-TERM INVESTMENT LAGGING

Senator HEINZ. Is it your understanding that long-term investment year to date is still lagging?

Mr. VOLCKER. It's rising. I don't have the figures in mind.

Senator HEINZ. All investment is rising. The question is whether it is lagging.

Mr. VOLCKER. It is lagging relative to some other forms of investment. Long-term investment interpreted to include office buildings and commercial construction is rising quite rapidly. I'm focusing on the manufacturing industries.

Senator HEINZ. If you left the commercial structures, office buildings out, which tend to correlate more with service functions as opposed to industrial activity, you would say that there is a definite lag, even though there is a rise, there is a definite lag in industrial investment long term?

Mr. VOLCKER. Yes; relative to earlier levels.

Senator HEINZ. Now I certainly agree with you that the Federal deficit is one of the causes of the high-interest rates. There is some disagreement on that. The Treasury Department says there's no correlation between high-interest rates and large deficits.

Can you rebut the testimony of Mr. McNamar and others before our committee which says there is no correlation?

Mr. VOLCKER. Let me say, first of all, there is no correlation in the superficial sense of correlation. If you look back in history, deficits tend to be big in recessions, and interest rates tend to be lower in recessions, and you would say there is an inverse correlation.

There's an obvious explanation for that. Interest rates are low in recessions because business demand is low, and the tendency for Government deficits to rise in recessions doesn't offset those other forces pushing interest rates down.

What you're really looking at is, other things equal, what do Federal deficits do? I know of no refutation to the argument that, other things equal, if you superimpose a Federal deficit on the credit markets and on the economy, you will get an expansionary force and an additional demand on the credit markets; with monetary policy and private incentives the same, you're going to get rising interest rates.

Senator HEINZ. There are two scenarios. One is overexpansion of the economy and inflationary pressures. The other is an increase in interest rates and deflationary pressures as economic expansion comes to a halt. And I worry as much about the latter as the former.

One of the reasons I worry is that it's very difficult to predict what future Treasury borrowings are going to do in the financial markets.

Now I seem to recollect that the Treasury Department will be doing only a modest amount, relatively speaking, of financing and refinancing over the next several months. When is the next major Treasury Department effort due?

REFUNDINGS INVOLVE A LOT OF NEW MONEY

Mr. VOLCKER. I think they've got a major operation at the end of this month. This is their normal quarterly, what is euphemistically called a refunding. The refundings involve a lot of new money these days. I may have their schedule of financing with me.

Senator HEINZ. My recollection, Mr. Chairman, is that they just did their refinancing 2 or 3 weeks ago.

Mr. VOLCKER. These days they do it every 2 or 3 weeks.

Senator HEINZ. They do it every Tuesday, but—so your information is that there is no particularly large Treasury operation planned other than monthly for the rest of this year?

Mr. VOLCKER. They have a large quarterly refunding and they have what they call minirefunding now that also add in many billions these days, too.

Senator HEINZ. The reason I ask, I seem to recollect that there is a big one due in November, but you don't happen to have that information.

Mr. VOLCKER. November would be a normal month, too. November is a normal month for a big refunding, as are August, February, May. In between, they have these so-called minirefundings which are bigger than the regular refundings.

Senator HEINZ. Did you say the minirefundings are bigger?

Mr. VOLCKER. Than the regular refundings we used to have.

Senator HEINZ. I take little comfort from that. So you do not see any particularly unusually heavy refunding, just a series of backbreaking ones?

Mr. VOLCKER. That's right. These are not unusually heavy by the standards of the past year; they are maintained roughly in the area of the past year.

Senator **Heinz**. So you see continuing pressure on the financial markets and very little end in sight absent additional action by the Congress?

Mr. **Volcker**. That is correct. I make a basic point: We are going to have a deficit next year as big as this year, and maybe bigger.

Senator **Heinz**. I think we agree on the fact that—at least you and I—I can't speak for the Treasury Department—both financing and refinancing in the market do drive up interest rates. But having settled that issue perhaps as the major cause of high real interest rates, I'd like to explore with you the area that Senator Riegle touched on, which has to do with bank performance in this area.

Do you agree or disagree with the notion that the quality of bank assets, the loans that they have held, has, notwithstanding the period of economic expansion, continued to decline in quality?

Mr. **Volcker**. I doubt that it's continued to decline in quality. I think we are still seeing asset problems, which were generated essentially earlier, reflected in the statistics.

Senator **Heinz**. Regardless of when they were generated, would you say that the quality of bank assets, regardless of when they were purchased, are stronger today than 1 year ago, weaker today than 1 year ago, or about the same?

Mr. **Volcker**. About the same.

Senator **Heinz**. And that's in spite of an economic expansion, in spite of record earnings by auto companies, for example.

Mr. **Volcker**. Yes.

Senator **Heinz**. That seems very odd.

Mr. **Volcker**. You might have seen more improvement by this time in the recovery against the background that you described. I think it is a reflection of the unevenness of the recovery.

Senator **Heinz**. And where are those weaknesses concentrated?

Mr. **Volcker**. I think without question in the energy area domestically.

Senator **Heinz**. Exclusively?

Mr. **Volcker**. No, but a big sector that was affected, not across the board, but broadly, I think you would certainly say the energy area. A lot of exploration was done, as you know, on expectation of sharply higher oil prices and when the oil price trend changed and those——

Senator **Heinz**. What other areas in addition to energy?

Mr. **Volcker**. I wouldn't put my finger on any other particular area.

Senator **Heinz**. In your statement you fingered leveraged buyouts.

Mr. **Volcker**. I don't think they've been a source of great difficulty yet. I was looking ahead; I don't want them or merger activity more generally to be the next source of difficulty. In the real estate area, we don't have the dramatic change that we had in energy, but I certainly think things are going on as part of the leveling off of prices that properly dictate caution in that area.

NEED FOR QUALITY LOANS BY BANKS

Senator **Heinz**. So you would disagree with the proposition that currently banks are making less high-quality loans than they were at previous stages in other economic expansions?

Mr. **Volcker**. I certainly hope that it is true that the quality is not deteriorating in that sense.

Senator **Heinz**. Well, it's an important question.

Mr. **Volcker**. It is an important question and certainly in our supervisory responsibilities and those of other agencies we should be encouraging prudent credit practices during this period. We are in the midst of a recovery. Let me also say that I don't want to suggest that I think the situation is such that everybody moves to the other side of the boat and becomes so cautious that they don't lend on anything. What we need is steady prudence in this area.

Senator **Heinz**. Mr. Chairman, I sense from your comments that it would take a considerable amount of time and probably some research, certainly on my part—perhaps on yours, I don't know—to become more specific about the quality of bank assets and I wouldn't want to pursue it any further because I am out of time. I would appreciate it, though, if you could answer hypothetically for me a question, and I stress it is hypothetical.

If it were true that the loans that banks were making were of less high quality this year than last or this quarter versus two quarters ago, would it not also be true that they would be seeking higher interest rates on those loans in order to compensate for the lesser quality or higher risk, and would that also not make it true that they would be willing to go out and bid for deposits more aggressively and thereby drive up interest rates by bidding for those deposits?

Mr. **Volcker**. Yes, but I don't want to accept the initial premise.

Senator **Heinz**. I'm not trying to get you to accept the initial premise.

Mr. **Volcker**. That could go on without the quality of the loan deteriorating. That process could go on with perfectly sound and prudent loans. If there are any temptations to weaken loan standards I want to guard against them. If that danger exists—and I alluded to it—I want to guard against it.

Senator **Heinz**. Do you think that there is any danger of it happening? Do you think that banks are trying to sustain the growth of their earnings on volume, as it were?

Mr. **Volcker**. I think there can be temptations that we should guard against. I don't want to suggest, on the other hand, that everybody crawl into a hole.

Senator **Heinz**. Mr. Chairman, my time has expired. I thank the members of the committee. What this leads me to conclude is that we need an oversight hearing sooner rather than later on the oversight capabilities and practices of the supervisory agencies—the Fed, the Comptroller, the FDIC. I have been troubled, of course, by the fact that there have been some reports that there were a lot of warning signs with respect to Continental Illinois in its annual report. I'm not an expert on bank examination, but I also wonder about the larger policy question which is whether in fact we are seeing, with leveraged buyouts being kind of the obvious tip of the iceberg, a a deterioration in the quality of bank loan portfolios in a time of economic expansion, and what the implications of that are for interest rates. I do not mean to suggest that that's going to be the major cause of high interest rates. I think the Federal deficit is going to remain that.

It would seem to me that we might want to have such an oversight hearing, Mr. Chairman. We can discuss that at another occasion, but I do believe that we have some major questions in this area both in terms of supervisory capability and, second, in terms of the effect of present practices in the banking industry on what in fact they are doing that might impact interest rates adversely. Thank you.

Senator RIEGLE. I'd like to, if I may, join in expressing a concern with the Senator from Pennsylvania and join in the request for such an oversight hearing because I think it would be useful for us to take a look at that.

The CHAIRMAN. Senator Lautenberg.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Welcome, Chairman Volcker. I'm sorry that I wasn't here to greet you at the opening of your testimony.

I'd like to start off by reading a quote here from the Brookings Institution report, "Economic Choices for 1984." It says:

> The United States is indulging in a boom of public and private consumption of assets both foreign and domestic. Future generations will experience a reduced standard of living, smaller capital stock and the burden of repaying that foreign debt.

Would you agree with that?

Mr. VOLCKER. I certainly think we are liquidating our net asset position, our investment position overseas, yes.

Senator LAUTENBERG. How about the reduced standard of living?

REDUCED STANDARD OF LIVING AVOIDABLE

Mr. VOLCKER. That depends upon a lot of other things happening between now and then. That refers to a very long-term process and I would say that is avoidable if we attack the problem now.

Senator LAUTENBERG. It's avoidable you say?

Mr. VOLCKER. Yes. It's avoidable if we take the right actions.

Senator LAUTENBERG. But you believe that it is an avoidable condition, that we can continue to maintain the same essential standard of living that we have now?

Mr. VOLCKER. We are talking about the rate of growth in the standard of living in all probability, and I think that is a direct long-term analysis that we're going to continue running budget deficits of this size, for instance.

Senator LAUTENBERG. So the focus then gets us back to budget deficits and how we deal with that. The President has indicated that he wants to reduce the deficit primarily through further cuts in Federal spending. Last night he effectively ruled out increases in taxes and I take him at his word. Perhaps you can help me understand what the implication there is. Take the 1985 budget approved by the Senate, endorsed by the administration. The deficit is $182 billion, total spending is $926 billion. It has 29 percent of that total coming from defense, nondiscretionary is 17 percent, entitlements is 46 percent, net interest is 13 percent, and a couple others offsetting receipts are $49 billion.

Assuming $10 billion in interest savings results from other reductions, it still leaves us $172 billion deficit.

Now where are we going to get the $172 billion without resorting to further taxes? Do you see any places that we can further cut spending that you'd like to point to particularly?

Mr. VOLCKER. No, Senator. I think this period, above all periods, is part of the political process. These are decisions that you gentlemen and the President are going to have to make; you're in the midst of debating them and I think that's entirely appropriate. All I would say is that I hope you act as forcefully and as soon as you can and resolve those differences about the particular approach to be taken. I expressed a general preference on economic grounds earlier.

Senator LAUTENBERG. OK. Just to make sure that we're clear on your recommendation, you want us to act quickly and forcefully. Is that taking the total picture? Does that include some tax increases?

Mr. VOLCKER. I think arithmetically that depends on what you can do with the spending.

Senator LAUTENBERG. I guess it's fair to say that we can't save it totally from spending. You said something earlier in your remarks, Mr. Chairman, about the fact that taxes as a percentage of GNP were—did you say at an all-time high or very high?

Mr. VOLCKER. They are fluctuating around the highest levels they have been. I don't know that they are precisely at an all-time high now, but they are running now, as I recall, 18 or 19 percent of GNP, which in peacetime at least, is as high as they have been.

Senator LAUTENBERG. Is there room for more?

Mr. VOLCKER. There's always——

Senator LAUTENBERG. Without destroying our economic growth or substantially impairing the living standards for the coming years?

Mr. VOLCKER. I can't say that some increase in taxes is going to destroy living standards. It depends on how you do it. I might just say—and I don't want to get into the pros and cons of particular measures—that the possibility of changing the way we go about collecting taxes, I take it, has been raised as a political issue and that's another dimension of this thing.

Senator LAUTENBERG. I notice in the report that I read recently that families in America who have an income of $1 million or more a year pay an average tax of 17.7 percent. I don't know how many families there are that make $1 million. I guess there are not a lot, but it certainly suggests some inequity there when the basic tax rate is something substantially higher.

Mr. VOLCKER. Total budget receipts, essentially taxes and other receipts, ran about 18.6 percent last year, 20.2 percent the year before. The highest figure I see on this table, which runs back to 1964 is 20.8 percent in 1981; it was 20.5 percent in 1969, got down in the low 18's. We're now estimating about 19 percent this year, so we're running in that range.

Senator LAUTENBERG. Is that a pure measure by itself? I mean, is that something that to you indicates we ought not to go any further, that that's as high as it's been and therefore it's plenty to take out of the economy?

Mr. VOLCKER. All that I've said is that, in general terms, from the economic standpoint, with expenditures that last year ran 20.7 percent of GNP—a high on this table by a considerable margin—from the standpoint of the functioning of the private sector in the economy, you would be better off doing it on the spending side. But now you have the question of how much you can do on the spending side. That gets into issues that I have no competence in. They are both technical and political issues, and properly so. If you can't do it on the spending side, then you've got to look at the revenue side.

EFFECTS OF LEVERAGED BUYOUTS

Senator LAUTENBERG. You said in your remarks that there is essentially no effect on capital markets of leveraged buyouts and I think you termed it neutral from the standpoint of real resources and general credit market conditions. Is that right?

Mr. VOLCKER. Looked at very broadly over a period of time, I think that's correct, yes. It does affect the structure of industry if there are enough of them.

Senator LAUTENBERG. You said that it affects the structure of individual businesses.

Mr. VOLCKER. If there are enough of them, it can affect the whole economy.

Senator LAUTENBERG. Well, it seems to me that there are enough of them to make a big difference. We saw huge investments made in acquisitions out of capital from the marketplace.

Mr. VOLCKER. I think that's correct. The figure I cited in my statement of a reduction in equity at an annual rate of $75 billion is a startling figure; that we are going down in equity or at least retiring equity at a time of great economic advance.

Senator LAUTENBERG. So that's a real warning sign, certainly in terms of the ability of companies and business generally to be able to finance themselves in the future?

Mr. VOLCKER. That is my concern; yes, sir.

Senator LAUTENBERG. And you also say in your statement that the supply of funds is not really inexhaustible. Would you think that there ought to be legislation restraining or restricting some of these leveraged buyouts in terms of the needs or the interest of the capital marketplace?

Mr. VOLCKER. I don't think a legislative solution is practical or desirable from what I see going on now. My major emphasis is that people should, in loaning the money, appreciate the risks. I think you can find leveraged buyouts that probably improve the effectiveness and efficiency of the particular unit that's at work; for instance, if you take out part of a big conglomerate or a big company and from the managers that are actively working on that part of the company as an independent organization with their own equity, there may be a particular reward for conducting that portion of the business independently, maybe it will work better. But I don't think that obviates the need to be cautious about this extremely high degree of leveraging that is involved.

Senator **Lautenberg**. Since there's a discount on the time expiration I noticed by my colleagues, I will take the discount for just 1 minute more.

COMPETITIVE EQUITY IN BANKING

Mention was made here of the deregulation phase that's going on in terms of banking, and the Continental Illinois problem is one that's highlighted the worst of the problem, I think, the worst of the possibilities. There are suggestions of other big institutions being shaky or in jeopardy and I wonder whether you would want to comment—or I'd like you to comment—you may not want to—in terms of whether or not the banking industry would just like to get out of the loan business and invest in other types of business and kind of feather their nests that way. I mean, when I see the ad that Senator Riegle pulled out and I see the suggested return is higher than the prime rate, I know that there's—I don't know how many borrowers borrow at prime rate, but there's certainly a problem trying to manage the spread between those to leave enough left over for the shareholders and the continuing expansion of the operation. I wonder whether in fact we are not inviting a further disaster and further problems by permitting the banks to move further. We have made decisions in this committee, a decision I supported, but we ought to be monitoring this situation pretty closely because I think we may be encouraging the banks who provide an essential service in our communities to get out of the business and get into other businesses that look for the moment like easier businesses. Any comment?

Mr. **Volcker**. I think most bankers want to be bankers, and I think that's healthy and that involves making loans. I think you find some people in the banking business—maybe I should state it that way—who see the future lying in other lines of activity.

As you know, the basic philosophy that I have expressed in connection with the legislation is that there is something special about banking and we can't have a complete mixture of banking and nonbanking business, although I think bank holding companies can legitimately somewhat expand their areas of activity. To the extent they can do that profitably, it may make for better banks as well by avoiding or relieving some earning pressure on the bank per se or an organization more broadly construed. I think that there are many more competitive pressures on banks today than there were 10 or 20 years ago, and that this leads to the reaction that they want to get in other areas.

Senator **Lautenberg**. Or abandon some.

Mr. **Volcker**. Or even to abandon them, if you took it in the extreme. Or it might encourage the kind of credit practices that Senator Heinz was concerned about in an effort to make money. In considering banking legislation, considering banking regulation, we certainly want to encourage them to do a good job in banking, but there are lessons for how their competitive position is legitimately protected, if I may put it that way. There are limits to what nonbanks should be able to do that really is banking, and there should be a demarcation competitively. That's what this nonbank bank argument is all about essentially; we ought to make a line of demarcation between the banking sector—with certain functions and with a strong governmental safety net—and other kinds of business.

Technology advances and those distinctions aren't easy to make, but there are ways they can be made. The committee is going some distance toward that in the bill you're dealing with. I still have some qualms, I must say, as to whether that could not be improved in some technical aspects in drawing those lines of distinction. For instance, there's some question just about the definition of a bank. I fear that the so-called thrift test in that bill may be so loose that in fact nonbanks could do a banking business in the guise of a thrift. There's a test in there and I welcome that; I just raise the question whether the test is set at a level that protects against the very danger that you may be referring to.

Senator LAUTENBERG. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Gorton.

Senator GORTON. Thank you, Mr. Chairman.

Senator Mattingly asked me to ask a question which I find to be an interesting one and I will start with that.

Chairman Volcker, in your opinion, can the Board maintain money growth stability within target ranges for the rest of this year without significant adjustments in bank reserve growth that could have a substantial impact on interest rates?

Mr. VOLCKER. That depends entirely upon what happens in the rest of the economy, Senator.

Senator GORTON. What factors?

Mr. VOLCKER. You've got a supply and a demand, so to speak, and we influence the supply factors. What's left unknown is the demand factor. We have been aiming to be in those targets. Now if the demand increases very rapidly because, let's say—a most obvious way is the economy expands very rapidly—you could well get pressures on interest rates, as we got during the first part of the year when that happened in terms of money growth and economic growth. If the economy slows down, you've got quite a different picture.

Senator GORTON. Do you expect a more rapid growth in the economy than we have had in the last 6 months?

Mr. VOLCKER. No.

Senator GORTON. You don't expect that at this point, do you?

LESS GROWTH IN SECOND HALF OF THE YEAR

Mr. VOLCKER. Our anticipation is for less growth in the economy and I believe that that is likely. I must say that most people believed that was likely 6 months ago too, but I do think that the probabilities are that the rate of economic growth will be slower in the second half of the year.

Senator GORTON. On another aspect of the supply and demand of money, you have expressed a concern, as have many others, with what can conceivably happen if foreign investors lessened the amount of money which they are investing in the United States on the value of the dollar. Obviously some reduction on the dollar's value may very well be desirable, but I presume that it would tend to cause inflation or be reflected in inflation, and that reduced capital inflows might tend to raise interest rates, partly depending on how the Board reacted.

If any serious flight from the dollar begins or if foreign inflows simply slow down considerably, which are you likely to view as the most serious potential problem—an increase in interest rates or an increase in inflation?

Mr. VOLCKER. The tendency, as you suggest, would be in both directions; they would be interrelated. There are no easy options for monetary policy in that kind of a situation.

Nobody is going to worry about fluctuations in the dollar within the range of the past 6 months or 1 year, but you raise a vulnerability that I just want to emphasize as strongly as I can; the only way I know of dealing with that vulnerability, constructively, in terms of what we want to achieve over time, is not have to do so much financing from abroad. If we reduce that source of pressure, and if we don't get so much capital inflow——

Senator GORTON. By reducing our own budget deficit?

Mr. VOLCKER. Yes, by reducing the budget deficit; I know of no other way. I think the best way to state the problem of the budget deficit is by pointing out that vulnerability.

To put it another way, we have succeeded in financing this deficit at quite high interest rates, in an easier way than we otherwise would have, because we are drawing on foreigners for capital at a rate of $80 or $90 billion a year. What you're raising is the hypothesis that that's no longer possible at some point. There's no signs of it diminishing at the moment, and I am not in any way forecasting it's going to diminish in the near term time horizon. But you have to ask yourselves whether it can go on forever. We'd better get prepared because it's not healthy in terms of our longer term economic growth and vulnerability.

Senator GORTON. Let me ask you a subsidiary question to that one. Is inflation divisible in any respect whatsoever. If an increase in the consumer price index over a period of several months were due solely to the fact that the value of the dollar was going down and therefore the cost of imported goods was rising without any accompanying increase in the price of domestically produced goods or inflationary wage increases, would you view that rather narrowly caused inflation over a few months differently and less alarmingly than you would regard an inflation in which there was a very substantial domestic component?

Mr. VOLCKER. If you can make that distinction, I think there would be grounds for viewing it differently. If you could say that this is a temporary, once and for all adjustment, I think you would view it differently. But, of course, the practical problem will be that in the end you don't divide it up so neatly. You can measure the import costs and it will certainly affect prices of things directly competitive with imports; then you get into how that affects pricing more generally, wage trends throughout the economy, and all the rest.

If you could distinguish and say this is a once and for all adjustment, we've just got to swallow it because the dollar is going to a new level but from then on the trend is going to be exactly the same, you would have a much easier problem to handle than if it's a dynamic process.

Senator **Gorton**. But you don't think that that's easily distinguishable?

Mr. **Volcker**. No. There is something to what you say, but, of course, it is a dynamic process, where the thread is that one thing affects another.

The **Chairman**. Mr. Chairman, if I could interrupt for a moment, there is a vote going on and to expedite as rapidly as possible, Senator Gorton will continue and I will leave and go vote so I can get back as quickly as possible. So when you are completed with your questions, we'll just recess until we get back.

Senator **Gorton**. Fine. I do want to ask you one question or maybe a couple related questions about Continental Illinois. Obviously, at least a significant part of that bank's problem was its heavy reliance on purchased deposits greater than the $100,000 limit on nominally insured accounts or what we might call scared money. Can you tell me, or can you find for me if it's not at the tip of your fingers, how many among our 20 or 25 largest banks have a significant portion or a portion as large as Continental Illinois of that kind of assets?

Mr. **Volcker**. The way we kind of arbitrarily measure these things, purchase money against other money, I think I can tell you Continental had the largest portion of any major bank, but there is a spectrum to this, obviously. A few other banks are relatively close; others are further away. My recollection is Continental was absolutely at the top of the list.

Senator **Gorton**. Does this indicate that our deposit insurance system might be equally ineffective at stopping runs on some of these other banks which are close to the Continental condition should they take place and, in turn, does that call for a significant overhaul of the Federal deposit insurance system in your view?

Mr. **Volcker**. I think there are conceptual problems, practical problems with the deposit insurance system, simply because of the passage of time and different attitudes over time—different kinds of bank financing, as you point out—that will deserve review and should be reviewed. I don't, myself, think this is the time to introduce significant changes in the deposit insurance system. I think basically it works pretty well and I would like to think this Continental episode shows that the deposit insurance system interacting with the Federal Reserve and vice versa is capable of dealing with these problems and containing them. But there are some issues that are spotlighted by this situation, spotlighted by some others, as to what the appropriate guaranteed insurance limits are, and how failing banks should be dealt with. I think they all are very relevant questions that should be looked at, and I know that Congress has done at least a little thinking in that area, but I would also say this is a very sensitive area in terms of psychology so changes should be introduced with due deliberation. People are familiar with the way the system works now and there's a certain benefit to familiarity.

Senator **Gorton**. Thank you. Why don't you take a break. I will go vote now so we will be in recess until the chairman returns.

[Recess.]

LACK OF TRUST BY FINANCIAL COMMUNITY

Senator **Sasser**. The committee will come to order.

Mr. Chairman, last night I watched the President's press conference and he was asked why interest rates were so high and in effect he said that the financial markets fear a revival of inflation, and the President indicated that he felt such fears were unjustified and that they were, if I could quote him, based on a lack of trust on the part of the financial community.

Mr. Chairman, I'd like to ask you this morning what your experts at the Federal Reserve say about this. What do they think are the real reasons for the high interest rates?

Mr. **Volcker**. I think that kind of anticipation and concern—I will speak for myself——

Senator **Sasser**. Well, you are the expert at the Federal Reserve.

Mr. **Volcker**. But I'm not alone in this. The concern about a rebirth of inflation, if I could word it that way, is a factor in markets and there is concern about reaching capacity levels, so to speak, in economic growth. There is certainly concern about budgets and the budget concern is dual. First, there is an immediate impact on the market obviously. There is also the expectation of a continuing impact in the market just from the weight of the budget deficit. Then, there is a great deal of concern—and now I'm getting into an overlapping factor—that those kinds of budget deficits in a period of prosperity will themselves have inflationary repercussions and make it difficult for monetary policy and so forth. There are concerns about the risks involved with the dollar that I was speaking about with Senator Gorton earlier.

Those combination of factors I think lie behind the uncertainty, the nervousness, and lack of faith, if you will, that you referred to.

Senator **Sasser**. So the President is right, then, when he says there is a lack of trust in the financial community and this arises because of a fear of inflation that's fueled primarily by a very large budget deficit. Would that be a fair statement, Mr. Chairman?

Mr. **Volcker**. It is certainly one of the factors in that concern.

Senator **Sasser**. Let me get into another area that's of some interest I think to the committee. I know it is to this Senator and you reflected on it briefly here earlier this morning. It was reported yesterday that there will be a $4.5 billion bailout for Continental Illinois, and that this is being concluded between the Federal Deposit Insurance Corporation and other affected parties.

$3.5 BILLION BAILOUT LOAN

Now central to this bailout is a $3.5 billion loan from the Federal Reserve Board to the Federal Deposit Insurance Corporation for the purpose of purchasing the problem loans at Continental.

Now I'd like to have further details about the loan, Mr. Chairman, for the record. Could you spell out the terms of this loan to the Federal Deposit Insurance Corporation?

Mr. **Volcker**. I think it would be inappropriate for me to describe arrangements that haven't been announced yet and, indeed, I cannot be sure of until they are finalized.

Let me simply say on that particular aspect there is a possibility, technically, of an assumption by the FDIC of loans that the Federal Reserve has already made to Continental Illinois.

Senator SASSER. Well, one of the concerns that's been raised, that I think this is without precedent to my knowledge——

Mr. VOLCKER. No, this has been done before.

Senator SASSER. Is it not?

Mr. VOLCKER. No. In several cases where the FDIC has assisted, either commercial banks or savings banks, the FDIC has assumed a loan that the Federal Reserve had made before to the institution.

Senator SASSER. In other words, then, in times past the Federal Reserve Board has loaned the FDIC money with which to purchase——

Mr. VOLCKER. I am just going to have to use different words than you're using. There have been times in the past when the FDIC has assumed the loan that the Federal Reserve had made to the assisted institution.

Senator SASSER. But never in this magnitude?

Mr. VOLCKER. No. I don't remember the size of the other ones off hand.

Senator SASSER. And you're making, if my memory serves me correctly, a loan to the FDIC that's roughly half the value of the insurance fund itself?

Mr. VOLCKER. No, no.

Senator SASSER. What is the value of the insurance fund?

Mr. VOLCKER. The figure that sticks in my mind is $16 billion, something in that neighborhood.

Senator SASSER. I had in mind $6 billion, so I dropped a digit.

Mr. VOLCKER. $6 billion may be the FSLIC, but the FDIC fund is in the neighborhood of $16 billion.

Senator SASSER. Well, it's been speculated that, reading here from the New York Times, it says the loan from the Federal Reserve has set a precedent that could point the way in which the two deposit insurance agencies, the FDIC and the FSLIC, could replenish their strained resources without an act of Congress, without substantially increasing the insurance premiums that they charge hard-pressed financial institutions.

To your knowledge, does that logic figure in this proposed arrangement, Mr. Chairman?

Mr. VOLCKER. If that kind of arrangement were adopted, it follows a practice that has a number of precedents, as I indicated, and fairly sizable precedents I'm reminded.

Senator SASSER. Can you recall off the top of your head the previous largest sized transaction of this kind?

Mr. VOLCKER. I can recall because somebody put a note in front of me. Franklin National Bank, about $1.75 billion when they were being assisted by the FDIC; Greenwich Savings Bank, a little less than $½ billion; First National of Midland, $600 million.

Senator SASSER. Mr. Chairman, I know that what goes on in the Federal Open Market Committee is not for public consumption.

Mr. VOLCKER. Let me say that it is for public consumption in the sense that, with a short delay, we do publish the policy record.

Senator **Sasser**. Let me just ask you this question. During the most recent meeting, was the vote of the Federal Open Market Committee on monetary policy unanimous?

Mr. **Volcker**. The vote on these long-term targets, yes.

Senator **Sasser**. So there was no dissension at all on the question of long-term targets?

Mr. **Volcker**. That's correct.

Senator **Sasser**. Mr. Chairman, your projections for a rising inflation in 1985 assume no major change in the value of the dollar. What would happen to inflation if the value of the dollar fell by 20 percent? Would such an outcome be unacceptable to the Federal Reserve?

Mr. **Volcker**. It's not up to the Federal Reserve to accept or not accept. We had to make some kind of uniform assumptions for these projections, and I didn't mean to imply that fluctuations within the general range of the last 6 months or so, which I think may have been more than 5 and less than 10 percent between ups and downs over that period, would be terribly significant. When you get into the range you're talking about, the kind of question that Senator Gorton was raising is relevant. It moves in a direction of increasing inflationary pressures. I don't think there's any question about that.

Senator **Sasser**. Is it fair to say that the Federal Reserve's present plans don't assume or allow for a depreciating dollar?

Mr. **Volcker**. I can't say they don't allow for it. We don't plan on it.

Senator **Sasser**. You don't plan on it, but you don't close the door that this could occur?

Mr. **Volcker**. There's a big market out there. We didn't plan on it appreciating either.

HIGHER INTEREST RATES DANGEROUS

Senator **Sasser**. Mr. Chairman, yesterday John Fall, the chief economist of Morgan & Stanley testified before the House on monetary policy and interest rates, and I suspect you have seen the quote. If you haven't, I will read it.

He said:

> The LDC debt problem and the liquidity problems of the U.S. banking system imply that sole reliance on monetary policy to slow the growth of demand in the U.S. economy could be dangerous. Pushing interest rates higher in such an environment conceivably could fracture the system and lead to a worldwide recession.

And Mr. Alan Sinai, a vice president of Shearson-American Express, said at the same House hearing:

> Numerous LDC's are under pressure. Large U.S. banks are under pressure as well because the loan repayment and interest burdens are insurmountable for some LDC's except perhaps through agreement to austerity programs that are politically unacceptable. Another cyclical rise in interest rates would run the risk of setting off an international financial crisis.

Well, I know you're concerned about this, Mr. Chairman, and I might ask you how much weight is given to the problem of the less developed countries' debt problem in the Fed's discussion of monetary policy?

Mr. **Volcker**. We discuss and evaluate that kind of problem, domestic problems of various sorts. Naturally, one considers all these kinds of factors and their interrelationship with interest rates. In terms of the general comments that those gentlemen are making, in this general line of questioning, there is no doubt in my mind that working with a different kind of fiscal policy would relieve the problems faced by monetary policy and make a better overall economic policy, a policy that would deal with some of these sources of strain and pressure in the only way I believe they can be dealt with effectively.

Senator **Sasser**. Is the State Department consulted for its views on political effects in various less developed countries if there are further interest rate increases by the Federal Reserve?

Mr. **Volcker**. They are consulted about conditions in those countries. I don't think they are particularly consulted about the specific interest rate question.

Senator **Sasser**. Mr. Chairman, I'm supposed to hold the fort here until the chairman gets back. Let me ask one other question.

Mr. Chairman, it's my understanding that a 1-percentage point increase in U.S. interest rates raises the developing nations' debt service by approximately $3 billion. How have recent interest rate increases affected the ability of the less developed countries to pay off their debts? Which ones are most adversely affected?

Mr. **Volcker**. The ones that are most adversely affected, quite obviously, are the ones with the most dollar debt. Of course, those also happen to be the biggest countries, by and large, so in relative terms it may look differently. But I would make one comment. It is a serious problem in terms of the additional cost involved. I think it's been more important recently psychologically rather than actually. I don't want to minimize the actual impact, but fears of further increases enter into the picture, too, in terms of the psychology of the situation.

I do want to point out the other side of the equation. Our growth has also been much more rapid than anticipated and that growth has direct favorable implications for these same countries in improving their export markets and a very healthy influence in terms of improving that part of the equation.

Senator **Sasser**. You mean our economic growth in this country?

Mr. **Volcker**. We bring in imports; that directly helps both their external situation and equally important has helped domestic business.

Senator **Sasser**. It doesn't help our deficit problem.

Mr. **Volcker**. It doesn't help our deficit problem. In a sense, it's part of our deficit problem, but it helps our inflation problem and it is enormously constructive, both in terms of the external position of those countries and, as I said, the expansion of export oriented industries in those countries that have to be part of the fundamental solution.

Looked at in that light, one has to also view the possible impact of very strong protectionist measures taken here, and whether we're not undercutting the ability of these countries to undertake what they have to do over a period of time to have a healthy economy.

DEBT OF 30 DEVELOPING COUNTRIES AT $400 BILLION

Senator SASSER. According to the International Monetary Fund, during 1983, about 30 developing countries had a total debt of approximately $400 billion at the end of 1983. Do you have any projection, Mr. Chairman, of what that debt might be at the end of 1984 and 1985? Would we see it increasing?

Mr. VOLCKER. Increasing at a much slower rate of speed than it has been increasing. Many of the major borrowers, I suspect, will not have any increase at all. I think that's quite possible in the case of Mexico. There may be a decline as some portions of debt get repaid in the short run.

Senator SASSER. How about Argentina?

Mr. VOLCKER. It should be true of Venezuela. It would not be true of Argentina as far as I can see. I think it's likely to be true of Brazil, although that's a country where the rate of debt increase ought to be significantly lower. Brazil had a great deal of discussion at the time a new money lending package was put together for that country 6 or 8 months ago—saying it wouldn't last, it was designed to last through the end of this year. Well, all indications are that it will last. Their external position has been improving faster than projected. Their current cash position is stronger than was assumed and indeed there are indications of some revival of some sectors of the economy.

Overall, when you consider at the kind of global figure that you're looking at, I would expect an increasing amount of debt outstanding—I don't have the figure in mind—but clearly at a slower rate of speed than those rapid years of the 1970's and early 1980's when debt was rising too fast to be sustained. The rise for most of these countries should be consistent with lower relative debt service burdens and less exposure of international banks relative to their own capital.

If that holds steady, and the bank grows and the country grows in nominal terms, the debt burden becomes less. We are beginning to see that process. It's slow so far, but if we are successful and if countries are successful, it will happen more rapidly over a period of time. Without an actual decline in the debt or even with some increases in the debt you will get a relative decline in the debt burden. If you can combine that with very sizable decline in interest rates, you would have a much different picture.

Senator SASSER. That same argument could be made or that same rationale could be advanced, could it not, Mr. Chairman, with regard to our budget deficit here?

Mr. VOLCKER. Obviously.

Senator SASSER. If GNP grows, then our deficit declines.

Mr. VOLCKER. That's right. It could be advanced if it conformed with the facts, but it doesn't. The debt is rising faster than the GNP and we are using up external assets and we're turning into a net debtor, so it doesn't fit the facts.

Senator SASSER. You said earlier that we're liquidating our net asset position abroad.

Mr. VOLCKER. Yes.

Senator **Sasser**. By bringing in foreign capital essentially to finance this deficit. And also our balance-of-payments situation deteriorates even further as we purchase more goods abroad.

Mr. **Volcker**. That is right. I hope that the balance-of-payments situation does not deteriorate further. There are some signs that it may be leveling out, but it's leveling out at a very large deficit. The balance-of-payments situation in part reflects the fact that our growth is much more rapid than other industrialized countries. It certainly reflects these problems in the developing countries as you mentioned. If their growth picked up some abroad, that would be a factor helping our balance-of-payments situation, but it has indeed reached a very large deficit.

Senator **Sasser**. Thank you, Mr. Chairman.

Senator **Riegle**. Could you yield just on that point?

Senator **Sasser**. I will yield, yes.

Senator **Riegle**. Thank you.

Senator **Sasser**. I'm going to yield right out the door.

TRADE IMBALANCE LEVELING OUT AT A HIGH LEVEL

Senator **Riegle**. Just to follow through on the point my colleague from Tennessee was making concerning the trade imbalance, which you say is leveling out—it may be leveling out, but at a very high level. It seems to me that with interest rates continuing to rise and the value of the dollar continuing to go up, putting greater strain on the underdeveloped countries in terms of paying their bills and so forth, that they in a sense are being squeezed into a tighter and tighter corner and they have to maintain their exports which become imports for us.

It seems to me that we may be caught in a situation here where if needs be they will have to lower their prices in order to continue to make the import penetration here simply because they can't afford to have that item disappear at this point. So I don't know that anybody has taken the cycle of actions and reactions far enough out here, but it seems to me that the countries that are sending in a lot of their goods really can't afford to have our trade deficit disappear any time soon because it's desperately important to them.

Mr. **Volcker**. They can't afford to have our import market disappear. We can get more competitive where most of our trade is, which is with the developed world. But you're right, they can't afford to have their import markets cut off. You talk about their pricing. The pricing that's relevant here is in dollars. That does not suggest that they have to run unprofitable industries at home in their own currency. They have had large devaluations, so in terms of their competitive position, it may be good. It does not necessarily imply that they have to engage in practices of great subsidization of their internal industry. In fact, we obviously would like to see that they get that internal industry on a sustainable competitive basis without a lot of subsidies.

But the declines in the exchange rate make them very competitive. It doesn't mean that the industry is unprofitable at home when it's attractive in the United States.

Senator Riegle. I'll just leave you with the thought that I'm concerned that the countries that are running the trade surpluses with us at this point are going to need to maintain those and therefore you could find a whole new element of deflation which we were talking about earlier in the sense that those trade differentials are ones that other countries would be very reluctant to surrender and I don't know that it's realistic to assume that somehow magically the whole trade deficit is either going to level off nice and neatly or work its way down. I'm frank to say I don't see how that's going to happen.

Mr. Volcker. Having the trade deficit level off at this level is not a wonderful projection; it is a very large deficit.

Senator Riegle. That's exactly right.

Mr. Volcker. Whether or not the trade balance of particular LDC's will become bigger or smaller depends upon where they are now. Mexico and Brazil went through a very sharp cutting of imports; they are going to have to increase their imports as they grow and they will have appreciable increases in imports. Currently Mexico is having an increase—not as big as they expected, but a sizable increase in imports—and I expect that will continue for a while. But they have got themselves in a position currently of having a sizable balance-of-payments surplus so they can absorb some increase in imports and, of course, they are our next door neighbor and a lot of the imports come from us.

Just to complete the circle—or get out of the vicious part of the circle that you're referring to—it would be an enormous help to have lower interest rates.

Senator Hecht. Mr. Chairman, I understand many of the questions that I have have been asked.

Many people say that the Continental failure is the tip of the iceberg reversing the Fed's deflationary course. Specifically, what impact will the Continental bailout have on the Fed's policy?

Mr. Volcker. I don't think it has any basic influence. In a technical sense, when we lend as much as we have lent to Continental Illinois, it puts reserves into the system and you may get some unevenness in our reserve position, but over time we have the capacity to take back with another hand what we put forward with the first hand. If you look at that as an isolated incident, it doesn't have any basic influence on our policy.

Senator Hecht. During one of our previous meetings, I stated that the feeling of the American people was that the FDIC was backed up by American taxpayers. You countered that the insurance fund was industry supported and did not represent tax support. When FDIC Chairman Isaac pledged to back up all depositors regardless of size of their account, didn't this go beyond the reach of the FDIC's fund and place the U.S. taxpayers in a risk position?

Mr. Volcker. One would have to assume that the fund was not big enough to handle the situation, which I think is contrary to fact.

PAID $2 DIVIDEND IN 1982 AND 1983

Senator Hecht. I'd like your comments on the Continental Illinois statement of roughly around 1979 or 1980 it became well known that the Penn Square failure in Oklahoma. In 1982 their earnings per share were $2.12 and they paid out $2 in dividends. In 1983, their earnings were $2.46 per share and they paid out $2 in dividends.

Do you consider this prudent banking?

Mr. VOLCKER. This is Continental Illinois?

Senator HECHT. Yes.

Mr. VOLCKER. You must be right about the figures if you have them in front of you. I didn't remember them just that way. But, over time, you obviously can't pay the dividends if you're not earning them.

If the bank or any other company feels that it has a temporary curtailment of earnings, it might choose to continue the dividend. Certainly Continental did continue their dividends quite late in the game here. It turned out it was based on their misapprehension of how serious the situation was.

Senator HECHT. Shouldn't it have become apparent, though, when the Penn Square Bank folded up that many of these loans would be tied into Continental?

Mr. VOLCKER. It was apparent at the time when the Penn Square thing broke. It was discovered at that time that there was a very large involvement by Continental and one could argue—and the argument becomes even better with hindsight—that it would have been better to look at the dividends right then, I think, with hindsight, that's an unassailable argument.

Senator HECHT. I have mentioned to you a couple other times at our hearings that I felt there was a double standard on banking where if the small bank had a problem the FDIC would walk in and curtail dividends. Do you think they were negligent in this particular case?

Mr. VOLCKER. No, and I don't want there to be any pointing of the finger at the FDIC. We supervise that holding company and the question was raised upon a number of occasions.

Senator HECHT. And you did not want to interfere?

Mr. VOLCKER. I think you could conclude from events we did not feel that we wanted to take an order, an official legal action.

Senator HECHT. Do you regret that now?

Mr. VOLCKER. I don't know. It's a judgment call. Basically, we don't want to get involved unless we have to in this kind of business decision. As I say, these things are easy to do in retrospect. You could have easily argued, and they would certainly argue, if their problems had turned out not to be so serious it would have been a great mistake, because it would have raised unnecessary questions; that's what the debate is.

Senator HECHT. If the assets of Continental Illinois would have been $100 million, do you think the FDIC would have walked in and stopped the dividend policy on the basis of problem loans?

Mr. VOLCKER. I think you would have to ask them, but I don't have any particular feeling that they would have necessarily had a legal order to require that.

Let me say I think there is some misapprehension. The FDIC can speak for itself, but speaking from the Federal Reserve standpoint—and I suspect it's true of the FDIC—there is a great effort when a bank gets in difficulty, whether it's big or small, to work with that bank and work in such ways that if it's possible that bank and banking service is maintained. In some cases that isn't possible, but very, very few banks—small banks I'm talking about now—have been closed in a way that the depositors lost money. This happened in a few instances. In most cases, the amount of large, uninsured deposits is very small in small banks. That's the way small banks are. The great bulk of their deposits are legally insured and in that sense guaranteed. Typically, we don't close banks at all, but a bank is not closed unless it's insolvent, unless its assets don't add up to its liabilities. That has not been the case in Continental Illinois. Typically, when that is the case, there is an effort to merge that bank into another one, often with FDIC assistance, so the banking services are not interrupted. That has been the typical way of handling these situations in small banks. Sometimes it's not possible. Penn Square was a case where it was not possible. It was not a small bank, but it was not possible in that instance.

Senator HECHT. Many people have accused you of believing that prosperity causes inflation. Would you comment on this?

Mr. VOLCKER. I don't think prosperity causes inflation. I think you could have excesses of demand and a relatively fully employed economy could clearly cause inflation.

Senator HECHT. Mr. Chairman, no further questions.

The CHAIRMAN. Mr. Chairman, back to some more technical type questions. We discussed earlier the uncertainties in the marketplace and many people have argued that a lot of this uncertainty is increased by the fact it takes 45 to 60 days for the results or public release of decisions by the Federal Open Market Committee.

TIMING OF OPEN MARKET COMMITTEE DECISIONS

Why can't the Open Market Committee at least give out to the public an immediate or relatively immediate summary of its decisions? Do you believe if you did that this could reduce some of the uncertainties and the speculation that goes on during that 6 weeks or 2-month period when everybody is trying to guess what you're doing and making decisions on the basis of their guesses?

Mr. VOLCKER. I think basically—and this is just a judgment I reach on the basis of my own experience in this area over many years—it would increase the uncertainty, increase the guessing about what we are going to do.

The CHAIRMAN. To have a summary of what you've done would increase the uncertainty about what you have done?

Mr. VOLCKER. Yes, because if that summary is going to be fair and honest—of course, it might increase the pressure to have a different kind of summary or have them much more frequently—it's going to discuss various contingencies. It's going to discuss various considerations that the committee had in mind, and people will speculate about that and say are these contingencies going to come about. There's much less confusion in the market about what we're doing currently. What they really want to know is what we're going to do next week, or next month, or 3 months from now. By definition, we can't tell them that. You might have the difficulty that they think they know more than they do. If we get out there and announce things aren't going to change, and then something changes 2 weeks from now and we draw up another announcement for the market 2 weeks later saying that things suddenly changed, they would say, "Well, you double-crossed us. Two weeks ago you said we haven't changed anything and we bought all these bonds because you promised things hadn't changed." We don't promise them a thing, except this is what we're doing until next notice; that's basically what we do now.

You can go back and look at the old reports and see which ones would have led to speculation in the market and which ones wouldn't.

The CHAIRMAN. What's magic about 45 or 60 days?

Mr. VOLCKER. Nothing.

The CHAIRMAN. If you want to play that kind of game, make it 90 days.

Mr. VOLCKER. There's nothing magic about 45 days or 60 days, and sometimes if we really want to change something we say so. We say it right then. When we change the discount rate, we say it. When we change what I would call policy in any basic sense, we tell them. When we change these targets, we tell them. What we are not telling them right away is what our tactical changes are—and I think they are tactical because they are within the context of the long-range policy that's announced—until we have had another meeting. There's nothing magic about 45, or 50 days, or 60 days, or whatever. They are released after the next meeting, so they lose the speculative interest they would otherwise have because we have had another meeting in between. It could be a shorter time period between meetings; the timing is just the vagaries of when the next meeting is.

The CHAIRMAN. Well, I don't suppose I will ever be here long enough to understand what I have just heard in context of what you and I have talked about about releasing weekly aggregates which everybody agrees cannot be accurate and yet people make financial decisions based on them.

Mr. VOLCKER. I think you and I agree that we might be better off not doing that. There are a lot of people who disagree with me. I'm giving you a rather technical response, I suppose, although I would argue that it's based on a lot of experience. But to put the other side of the coin forward, I have no problem when we're changing what I think of as policy, which obviously is done quite infrequently. We announce policy changes. In October 1979, we announced one before the market opened, a very large change. We made a special announcement in the fall of 1982 when we deemphasized M1. When we announce these targets, we announce them as soon as we can mechanically and surround them with an explanation, fitting in with your own schedule.

I think a change in policy, a change in approach, should be announced as soon as it can be explained in context.

The CHAIRMAN. What I'm driving at is—and I have often asked questions of a technical nature—lag reserve accounting and all those sorts of things because in the years I've been on this committee I have found that psychology and perception have such an enormous impact on what is going on out there.

Mr. VOLCKER. I agree with you.

The CHAIRMAN. And I have not been one who has been critical of your overall policy. As you well know, I have supported it over and over again, but I have been highly critical of the technical implementation of that policy. So again, as I continue to hear from a lot of different people and hear the weekly figures released that nobody agrees are accurate and people base decisions on them, and then we have 45 to 60 days in which we wait and have people making decisions on their speculation, I guess neither one of us will fully understand the other one on this point. In other words, I agree with you. I supported your policy. I've supported your reconfirmation, but I still think technically speaking and mechanically speaking, we could do a better job.

Mr. VOLCKER. I'm not so sure we have any disagreement on the money supply figures. I think the trouble with your position and my position on the money supply figures is we can't convince enough other people.

I would be perfectly happy to publish them less frequently myself. We do have a technical problem there—technical may not be the right word. If we are collecting the numbers and people have all that interest in them, I don't like to sit on them for a few weeks, simply because there's just too much risk of the figure getting out anyway. We try to maintain confidentiality of these things and I think our record is very good, but I don't want to put that kind of a strain on the system.

The CHAIRMAN. Let me change to another subject. Time is fleeting and I apologize for the length of your testimony today, but I can't control the Senate floor or votes and I believe when I'm finished Senator Riegle is the last questioner, but let me turn to another subject.

LACK OF NATIONAL TREATMENT FOR U.S. BANKS ABROAD

Last fall I introduced legislation that would attempt to secure more national treatment for U.S. banks operating abroad. I have not pushed that legislation particularly hard because I wanted some of these foreign countries who were being particularly discriminatory to our banks while operating in our country with national treatment to see if they would get the message. Some of them have a little bit. There have been some tokenism out there with Australia and some of the other countries. But the Treasury recently released a report on 16 foreign markets indicating a continuing lack of national treatment for U.S. banks in those areas.

So I'm getting to the point where if not enough action is taking place, I think not only should I push that bill but maybe make it tougher because of the very unequal treatment by foreign governments of our banks.

What's your opinion of the importance of pushing for national treatment for U.S. banks abroad?

Mr. VOLCKER. You were thinking in terms of your bill, as I recall, which puts in reciprocity.

The CHAIRMAN. It would simply require the Comptroller of the Currency to consider when looking or when about to rule on an application by a foreign bank to consider treatment of U.S. banks in that country. So, yes; you are correct, it's reciprocity. How do they treat us and if they're not treating us well, maybe we will treat them the same way.

Mr. VOLCKER. I have some sympathy—and I thought we had some correspondence on this earlier—with what you're driving at.

The other side of the issue that's pressed upon me is that this involves very difficult judgments in particular instances; whatever foreign countries do, it is basically good policy for us to allow others in to compete on an equal basis with us and, as a practical matter, you get into a contentious series of questions that are very hard to evaluate.

I come down on the side of saying I think it is reasonable for this to be a consideration that should be looked at.

The CHAIRMAN. Well, some of the lines are not hard to draw. You look at Australia. They have had two reports—a Martin & Campbell report down there and they've decided to open it up to a few foreign banks. They have had none. Yet there are Australian banks that operate in as many as five States that end up having superior privileges to our own domestic banks which cannot operate across State lines. That is very, very clear and there are other countries that are doing the same sort of thing, and I see no reason to grant an Australian bank a permit to operate in five States in the United States when they allow no retail banking yet of U.S. banks in Australia.

Mr. VOLCKER. Let me just suggest one kind of problem. We allow them freedom. In fact, you can argue, in some respects, that foreign banks have more privileges than American banks in the American market, in terms of interstate banking. We are a very large market. You can at least raise a question as to whether a country with a very small banking system, in absolute size, may wonder whether permitting the full degree of access in their country that we have, let's say, with our very large market, would leave them with a banking system; we've only got to buy a couple of institutions. Is there any point at which a country in that kind of a situation might legitimately feel that permitting some foreign competition is one thing, but having foreign banks dominate in the economy is another? Simply because of absolute size that question doesn't arise in the same way here, but it does arise in those countries, and that's a difficult issue for me.

The CHAIRMAN. Well, I understand what you're saying, but some of the cases are so discriminatory.

Mr. VOLCKER. I agree with that.

The CHAIRMAN. We could go a long, long way before we ever reach any point of dominating there.

Mr. VOLCKER. That's why I've expressed a degree of sympathy for what you're saying, but I do, in conscience, want to report the arguments that many others have against it.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman. I'm going to shortly get back into an issue that Senator Hecht was raising a minute ago, and I want to preface my remarks by saying to Chairman Volcker that, as you well know, I have great respect for you and have expressed that many times in many forums and it continues today. So, when I take exception to something you say, it ought to be against that background of very positive feeling toward you and the professional way in which you exercise your duties.

But I must say that when I asked earlier the question about how many banks and S&L's are on the problem list you bypassed that because that data was not immediately familiar. But I am concerned, as I put that together with some of the responses to Senator Hecht, about the structure of the financial system right now, both in this country and abroad. I think there are all kinds of red lights flashing and I think we ought to deal with it with the degree of seriousness that it deserves. Perhaps we have a stark difference of opinion on these financial signals and if we do, fair enough. I want to get that on the record. But I don't want us to, in a sense, make it appear as if those structural problems are less than they are.

SUPERVISION OF CONTINENTAL ILLINOIS QUESTIONABLE

I don't think the supervisory job that was done in Continental Illinois was very good. I think there was an incredible failure of the supervisory procedure and when I read today, as I do in the Wall Street Journal, that the Continental Illinois shareholders—and obviously they must take the major part of the beating here—that's the nature of common stock holdings—but when I read that they could receive as little as one-thousandth of a cent for each of their shares under a Federal plan to bail out the bank, I ask myself where were the regulators earlier in the game when this kind of fiasco was developing. It seems to me the oversight procedures were not at all adequate and the schedule of dividends paid out by that institution when it was sinking into deeper and deeper difficulty, only increased the problem. It seems to me we need a better answer for where the supervisors were when this situation was developing because now we find ourselves today with the fact that the Fed is about to come up with $3.5 billion. I don't know where that money is coming from, but obviously it's coming from somewhere. It's real money or make-believe money. It's money that's not going to be available, capital that's not going to be available to somebody else because it's going to be used in this situation. So, this is not a cost-free exercise that we are undertaking here by any means. We've had to suspend the laws again on deposits over $100,000 and basically hold everybody harmless while setting up a sort of double standard where somebody invested in the big money center banks are in trouble, they're treated and protected one way under the law whereas other people across the country presently with deposits in excess of $100,000 in smaller institutions presumably are under the same written laws that exist at the moment and they are not protected. This type of reaction on the part of Federal regulators creates uncertainty in our financial system to say the least.

Mr. VOLCKER. Wait a minute, Senator. As I indicated earlier, with a small bank or large bank, if it's possible, there is an effort to merge that institution to render assistance and keep the bank open. In some cases, that's not possible, but it's been done with a great many small banks as well.

Senator RIEGLE. Let me ask you this, though. Have there not been instances in the last couple years where there's been bank failures where depositors with deposits in excess of $100,000 have had to take the loss above that figure?

Mr. VOLCKER. There have been some instances of that kind.

Senator RIEGLE. So, we have had on the face of it in a contemporary timeframe that kind of unequal application of the law, have we not?

The CHAIRMAN. Would the Senator yield?

Senator RIEGLE. Well, I will, but I don't want to digress.

The CHAIRMAN. I have heard this as chairman of this committee, I get it every place I go from the small banks. Now whatever the case is, the regulatory failure or nonfailure, with Continental Illinois, let me put it bluntly. That is just a phony charge that we have singled out one. I get a little bit tired of hearing it. I'm not singling out you. I'm talking about over and over again because I sat through as chairman of this committee when there were more on the trouble list and the S&L's from 1981, and 1982, and 1983 and the vast majority of those were handled exactly the same way with assisted mergers which not only preserved those over $100,000, dozens and dozens of them. Dick Pratt, of the Federal Home Loan Bank Board, he handled more failures in 1982 than in the entire history of the Federal Home Loan Bank Board combined, and most of them were handled on an assisted basis where all the depositors, without regard to the $100,000 limit.

So, yes, there are examples, Senator Riegle, where there were some that were not, but the vast majority were handled on an assisted merger basis, because, believe me, I heard about every one of them. Every day I would come to work and look at the ones that Dick Pratt and Bill Isaac were handling on an assisted basis, day after day after day, and it not only solved all those depositors' problems, but it saved the FDIC and the FSLIC a great deal of money. It costs a lot less to go into those assisted mergers than if they had just gone in and simply said, OK, we bail out everybody with $100,000 and everybody else loses. The cost of those insurance funds would have been incredibly more than through the assisted mergers.

So, pardon me for interrupting, but I don't think it's fair to constantly use Continental Illinois to say that the small guys weren't protected when the factual record shows that dozens—and dozens—hundreds were handled on an assisted merger in S&L's and banks through that period of time.

Mr. VOLCKER. I have some figures in front of me that reflect the point you're making.

The CHAIRMAN. Before you go on, the clerk will not take that time from Senator Riegle. Do not deduct my time from Senator Riegle.

Mr. VOLCKER. There were 10 bank failures in 1980. In seven of those, deposits amounted to $200 million and were handled by purchase and assumption, in the jargon; three of them with the total deposit amount of $16 million were closed. I don't know what the loss was to the depositors but I would guess there wasn't any. The banks were so small they probably didn't have uninsured deposits which may be the reason they were closed. In 1981 there were eight purchase and assumptions for a total amount of almost $4 billion; there were two banks closed with a total amount of $48 million. Again, this was total deposits, not uninsured deposits. They were very small banks. In 1982, 27 purchase and assumptions; there were 7 closed and that included over $500 million in deposits because Penn Square was in there. We looked for a way to keep Penn Square open. The bank, in that case, was much too far gone; you couldn't do it. That gives you some sense of the situation.

Senator **Riegle**. The point I'm making, although I don't want to get into a debate on the issue that the chairman of the committee is raising, is that I think there's a clear failure on the oversight procedures of the regulatory agencies with respect to Continental Illinois, and you may disagree, but basically to have to step up with $3.5 billion right now as part of the rather tortured workout of this situation, which may or may not succeed over a period of time, represents this type of failure I'm referring to. If proper foresight were exercised early on—and I'm not speaking of crystal ball-type predictions, just proper regulatory oversight—then we would not now be forced to come up with such a staggering amount of capital in order to bail out Continental Illinois. In this sense, I'm concerned about how many more there may be coming behind it.

Mr. **Volcker**. Nobody is patting themselves on the back. I mentioned earlier that we are the supervisor of the Continental Illinois holding company, which is fairly small outside the bank. We are not the primary bank supervisor and I don't intend to direct my——

Senator **Riegle**. I wasn't saying you are.

Mr. **Volcker**. I don't want to direct myself to that question, but I just want to make a general comment that banking supervision has a large job to do to keep the system safe and sound. I don't think you can have a system that's going to guarantee with the kind of enormous and complex banking system we have—proof against failure. If you had that kind of system you would smother it absolutely. That's the only way you could get that kind of system.

NEED TO FLAG PROBLEMS EARLY

Senator **Riegle**. You should run a supervisory system to try to flag these problems before they end up as a disaster as they surely failed in this case.

Mr. **Volcker**. I agree, we want to look at these problems in the future. I just want to remind you that I have urged this committee again and again to consider new banking legislation and the types of activities, from the safety and soundness standpoint, that banks and their holding companies should be permitted to engage in.

Senator **Riegle**. I think that's a very important statement and I share that concern exactly as I've heard you express it before.

Now I think we need to know where the $3.5 billion is going to come from to bail out Continental Illinois.

Mr. **Volcker**. The $3.5 billion does not disappear from the system.

Senator **Riegle**. But where does it come from?

Mr. **Volcker**. You're going on a newspaper report which describes a transaction which is certainly under consideration, where a loan of the equivalent amount of $3.5 billion that we already have made to Continental Illinois would be assumed by the FDIC. It doesn't involve any new money. It's already been lent.

Senator RIEGLE. Where does that money come from? You take that money from where in order to allocate it to this purpose which you have already done?

Mr. VOLCKER. In effect, if we keep our balance sheet in total unchanged upon making that loan, like any other loan we make or any other discount we make, whether to a commercial bank or others in very rare instances, the offset in an unchanged monetary policy would typically be in reduced holdings of Government securities on our balance sheet.

Senator RIEGLE. Take me a step further then. In other words, where in a sense does the $3.5 billion or so, where has that been displaced? In other words, somebody else presumably would have gotten it.

Mr. VOLCKER. If somebody withdrew a deposit from Continental Illinois, they couldn't replace it. A lot of people withdrew deposits. We replaced those deposits. At the same time, we sold Government securities. To simplify the process, the people who take the deposits out of Continental Illinois buy the Government securities, so there's no real capital used. There is a reshuffling of different assets among different holders, but the deposit that was in Continental Illinois in effect ends up in the assets that we sell indirectly; the deposit is replaced by borrowing from us.

Senator RIEGLE. Well, I guess what I'm trying to understand and I want to get is an the explanation so that a lay person can understand it.

NO NEW CAPITAL INVOLVED

Mr. VOLCKER. There's no new capital involved here.

Senator RIEGLE. But what I'm asking is this. If we did this, say, in 10 instances at once so we were not talking about $3.5 billion but $35 billion, presumably we're not just inventing money that doesn't really exist. Presumably, that, in a sense is a credit or a credit equivalent that's being established and used that takes away from something else.

Mr. VOLCKER. No.

Senator RIEGLE. So you're saying presumably we could get as many of these as we want without any consequences?

Mr. VOLCKER. It changes the composition of our balance sheet and it changes the composition of the rest of the world's balance sheet. Somebody has borrowed from the Federal Reserve; somebody holds more Government securities; they offset each other.

Senator RIEGLE. So you can make any number of these loans and basically it's just an accounting transaction and nothing is really altered?

Mr. VOLCKER. The limits on our ability to make such loans are very broad, obviously, and by design. The system was designed to do precisely this. The real limit is only the amount of money we put on our balance sheet in accordance with the needs of monetary policy. It's the same money; we just put it out in different form.

But we have the concern about the overall amount of money that goes out.

Senator **Riegle**. Well, it seems to me that one of the many problems here, in addition to bad supervision, is that it appears to me you're sort of going in two directions at once. On the one hand, there's some concern about outstanding credit at the present time, and in this transaction in effect you're giving credit.

Mr. **Volcker**. That's why we pull it back with the other hand.

Senator **Riegle**. I guess what I'm trying to understand is the degree to which you can continue to do that, the degree to which you can continue to add these one on top of the other and go in two different directions at the same time and in a sense say, "don't worry about it, everything is fine."

Mr. **Volcker**. Let me get to that point in a second, but let me just try to pin something down here. The operation that we are engaged in in lending to these banks—Continental Illinois in this case—is the most basic function of the Federal Reserve. It was why it was founded, to serve as a lender of last resort in times of liquidity pressures of this sort, so that they don't spread through the rest of the system to innocent parties not involved in Continental Illinois at all; we were founded so that there should be that elasticity in the system. That's what a central bank is all about, to provide liquidity in those circumstances. We are just carrying out the most classic function of a central bank.

To deal with your other question, one could imagine situations in which the amount of liquidity assistance was great enough, in disturbed enough market situations, that you didn't pull all the money back. In those circumstances you presumably wouldn't want to pull all the money back, and that's a difficult judgment to make. If you have a more generalized kind of liquidity problem, you ought to be providing more money to the economy. Just how, when and how much is a difficult concern, but that is again the job of the central bank.

Senator **Riegle**. It sounds to me, though, as you yourself acknowledged a minute ago, this sort of has you going in two different directions at once.

Mr. **Volcker**. There's no doubt in the immediate sense it has you going in two different directions at once. In the technical operations you're going in two different directions at once.

Senator **Riegle**. I want to relate this to one other point here and I'll finish quite quickly. That is, the thrift industry—I asked the question before as to how many thrifts we have in trouble and how rapidly that problem is growing, and the sense that I have is we've got a developing problem there, in addition to the problem of banks that are in difficulty.

RISE IN INTEREST RATES COULD WIPE OUT THRIFTS EARNINGS

But the thrift industry estimates that for each percentage point rise in interest rates that it reduces thrift income nationwide at the level of about $1.2 billion a year, which means that if you take the 2-percentage point increase in rates that we have had since the beginning of the year, and if that continues, it will wipe out, if you will, almost $2.5 billion in thrift earnings that otherwise might occur. If we continue on that track, that's going to more than eliminate the $310 billion in pretax operating and earnings that was earned by all the savings and loans in the country last year. In other words, their aggregate margins are very small to begin with as they labor back out of the last calamity that they were in.

I'm wondering, as you look at this situation, can you put me at ease and tell me I ought not to be worrying about this problem with respect to the thrifts, or do we have a problem developing here of size and consequence that we'd better pay attention to rather quickly?

Mr. **Volcker**. I certainly think that is a problem. I mentioned it in my statement. It follows directly from increases in interest rates. I think the only question you're left with is how constructively do we deal with that problem? Again, I think the answer is obvious.

Senator **Riegle**. Well, the one thing that I think we need to get from the Fed and I'd like to ask that this be done, recognizing that there are a lot of different players in the act, I think we have to take a look at the financial system and the credit system, the banks directly involved, the S&L's, and credit unions. I also think we have to take a look now at the degree to which you have a rising number of institutions in difficulty, not to the Continental Illinois degree yet and hopefully not to that degree any time soon, but the statistics that I have seen show an alarming increase in problem situations. It seems to me that one thing the Fed ought to be doing is tracking that, adding it up and trying to in a sense be able to make some interpretative comment to us about it as to how big the problem is, the rate at which it's changing, and what steps, if any, are needed to correct the situation. We need to look at the deposit insurance system, as well as other factors in addition to just macroeconomic policy recommendations which obviously need our careful scrutinization.

Mr. **Volcker**. I agree with you in general. I made some comments about deposit insurance earlier. I just think this piece of legislation before you is a very constructive piece of legislation and I think it's in the general framework that we talked about in common. I just repeat that one of my concerns about that legislation is that it recognize precisely the kind of concerns that you're expressing now, that it gives us the structure in the banking system that is inherently safe and continues to be safe. I think we have such a structure, and I think we have a very strong safety net under it, but the kind of things that you raise should be constantly reviewed. We do it. I don't think that the number of problem banks that has already become evident to you is in itself of great significance and I don't keep it on the top of my mind. But we do track and should track developments in this area.

You cite some trends that I don't think are evident, certainly not in the degree to which you seem to think. There are more nonperforming loans reported than was the case several years ago, but they are not on any sharp upward trend, and you wouldn't expect them to be at this stage of the cycle.

Senator **Riegle**. Well, am I incorrect in believing and being told that there are roughly 700 banks on the problem list?

Mr. **Volcker**. I don't remember the number on the problem list.

Senator RIEGLE. Therefore I infer from your comments that the figure of 700 is way off the mark.

Mr. VOLCKER. I don't want to infer that. We've got 14,000 banks in the country. A very small bank on the problem list obviously doesn't have the same significance as another bank, and the problem list does not imply by any means failure. It doesn't imply they are on the edge of failure. I don't want to leave that implication at all.

Senator RIEGLE. Well, the concern I want to express to you is that we are all focused on Continental Illinois because that's not a small bank. It's a major bank.

Mr. VOLCKER. There's no question about that.

Senator RIEGLE. It's right in front of us and we're in the process of the largest bank bailout that I'm aware of in the history of the country. I am concerned as to how many more may be following behind it. I see interest rates rising and I see the thrift industry which has been laboring so hard to keep afloat for the last 3 years now pushed back to the point where they're coming in for help—I don't know if they're coming to you or not, but they are certainly coming to me. There is, in effect a great deal of apprehension from the thrift industry about the erosion of the small profit margins they are presently working under and many of them are going back into problem situations.

Mr. VOLCKER. I am fully conscious of that and all I can say is that there is a constructive way to deal with this situation, not just for the thrifts, but for the farmers, for the LDC's, and other sources of strain in the system. I don't know how you deal with the situation constructively without relieving the borrowing pressure on the total market that comes from the Federal Government.

CONCERN FOR THE STRUCTURAL STRENGTH OF THE FINANCIAL SYSTEM

Senator RIEGLE. We agree on that. My question is in a different vein. That is, I think we need to have an analysis of the degree to which we are pressing against the structural limits that are there and I don't sense that that work is being done and I'd like to have it done. I'd like to have somebody at the Fed take a look at the aggregate problem of bank difficulties, savings and loan difficulties, and as you say everything is dynamic. We are looking forward. We are projecting where things are presently taking us. I think a large part of the apprehension in the financial markets and in the stock market right now concerns the structural strength of the financial system, touching on many of the things we've talked about, including the foreign loans and a whole host of other things.

Mr. VOLCKER. We keep all these things under review. We don't have a nice, neat little report that's going to give you some trend lines converging at sometime. I don't think that's the nature of the problem. But if you're telling me we're agreeing upon two things or three things, I'm perfectly happy to agree. I think we ought to deal with this general problem that we are talking about, which certainly lies at the source of the interest rate problem which aggravates all the other problems you referred to.

I don't think there should be any misapprehension out of the Continental Illinois situation or anything else that we don't have the capability of dealing with these particular incidents if and as they arise. One can always review these situations and we always try to learn and should learn lessons for the future out of any of these situations. I would be glad to review what lessons there may be in this for banking supervision or regulation in the future. I'm repeating myself, but those lessons are not irrelevant for the legislation before you.

Senator RIEGLE. We might get faster action on the macroeconomic policy adjustments which you and I agree are needed and needed now in a major dimension, but if there is a feeling that the structural system is fine and dandy and can take these stresses and strains and we don't have to worry about that, then that diminishes the likelihood we're going to see the policy actions that we need to take.

My sense is that the structural problem is now more severe than it was 6 months ago or 1 year ago.

Mr. VOLCKER. My sense is, if you're that concerned—and your concern seems to be somewhat exaggerated in my view—you ought to be out there leading a parade for a budgetary action right now without worrying about any report from me.

Senator RIEGLE. Well, we're doing that, Mr. Chairman, but what I'm trying to do today is to ascertain the degree to which you think there's a structural problem and I basically get the sense that you don't really have much apprehension in this area and you're certainly entitled to that view. What I still don't have is that I've asked if the Fed could take a look at this and give us some data so it isn't just an impressionistic response by either myself or anybody else.

Mr. VOLCKER. We can give you some data. I'm not sure all that data is terribly enlightening. You could have wonderful data about Continental Illinois bank until about June 29, 1982. Apparently with the benefit of hindsight, it was not very reflective of the situation. The management of that bank won some prizes for being the best managed bank in the United States.

Senator RIEGLE. I trust they had to give the prizes back.

Mr. VOLCKER. I just suggest that there are intangibles here that are not susceptible to easy statistical analysis and I don't want to leave out the intangible of the strength of the safety net that we have to deal with things of this sort that can arise inevitably and without much warning.

Senator RIEGLE. I just hope that we don't leave the impression that the safety net is infinite in size and we can take any number of failures at once, because I don't think you believe that and I know I don't believe that and that's what I'm trying to get at. That's the question: The degree to which we are finding ourselves with an overall buildup of pressures on the structure which we'd better pay attention to and we would be well advised to eliminate rather than just gloss over them.

Mr. VOLCKER. To the best of my knowledge, there were characteristics of the Continental Illinois Bank that were unique. I mentioned that earlier. My memory is about a statistical analysis of reliance of borrowed funds; they were at the top of the list.

The CHAIRMAN. Mr. Chairman, we appreciate your patience. Let me just say in conclusion that I don't think there is anybody in the regulatory agencies, or on this committee, or in the Congress who glosses over the problems. My experience is that this is being tracked on a daily basis and I believe that there needs to be structural changes in the regulatory system for the banks and savings and loans in this country. That will come. It cannot come until we decide who's going to be doing what and whether we go to functional regulation or what. That will have to be done over a period of years. But I think you made a very significant point. We in Congress can point fingers at the regulatory structure. I don't care what we do with the regulatory structure, the FDIC, the Fed or anything else, even when you've made some mistakes, even when hindsight shows maybe in Penn Square the FDIC should have been there and closed them down earlier.

GOVERNMENT SPENDING MORE THAN IT TAKES IN FOR 40 YEARS

I'm talking about overall regulation. Until Congress gets their act together, until we come up with some figures, I don't care what we do with the structure. I don't care what we do with the powers. The fundamental problem is spending more for the last 40 years and continuing to do so than we take in. The economy, the savings and loans, the thrift industry, the banks—how can you tolerate borrowing more than 70 percent of the net domestic savings of this country? The problem lies here, among those of us who are elected to be Senators and Congressmen, no matter how much we may try to blame somebody else—and I agree with the Senator from Michigan—there is blame to go around other places, but there are some structural changes we ought to be aware of. We ought not always be dealing with hindsight. We ought to have more foresight before these things occur, whether it's Continental, Penn Square, whether it's the Jake Butcher situation in Tennessee. We can all look back and we ought to learn from that. So there's a lot of fingers in the pie that causes these problems, but I just have to state once again that the fundamental problem—until that is cured—and that is the matter of this inordinate amount of spending as a percentage of gross national product, the inordinate buildup of deficits. When you look at the deficits, what are we carrying—whatever the deficit is—$180 billion, $125 billion of it is interest on past excessive spending by the Congress of the United States. You notice I'm not mentioning Democrats, or Republicans, or Presidents, or anything else. I'm talking about Congress as an institution. It simply will not discipline itself. When I go home and spend 3 weeks at home, I try to get that message across to my people—quit looking for scapegoats everyplace else, just look at your elected representatives, without regard to their political party, without regard to what they are running for, and look at their voting record and see if they vote the way they talk. If they talk about balanced budgets and deficit reduction and so on, but their voting record doesn't match that, then get somebody else, regardless of political party. We are the ones that are responsible basically, with others aggravating the situation.

I think it's fundamental that before we get into the structural changes which we should do. I agree with the Senator from Michigan. There are a lot of other things we should do. But interestingly enough, who does that relate back to—whether it's the deficit, whether it's making structural changes, whether it's trying to set some policy—it's Congress. We're the only ones by the Constitution given the power to pass laws in this country. No one else is. Others can interpret them. The Supreme Court can decide whether we are constitutional or not. But ultimately it lies with us. I don't know that I ever had any hope for 535 prima donnas, each thinking they have the individual answers to all the problems of this country if they could only be a dictator for a few days we would solve it all. I don't know whether we are institutionally capable, 535 people that put out press releases, get on TV, and so on—I don't know that we are capable of coming to grips with some of these problems. It's much easier to look elsewhere rather than looking inward to the only body that's given the power to appropriate money and the power to pass laws in this country.

I appreciate your patience this morning and we will look forward to 6 months from now. Hopefully, things will continue to improve and we will have no more Continental Illinois situations.

Senator Mattingly has some additional questions for the record. Senator Trible was not able to be here and he has some questions. And I have some additional questions but due to the length of time I will also submit these for your response for the record. Thank you very much, Mr. Chairman.

[Response to written questions of Senators Garn, Mattingly, and Trible:]

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

QUESTIONS SUBMITTED BY CHAIRMAN GARN
RE CONTINENTAL ILLINOIS
July 27, 1984

1. Understanding the delicacy of the current negotiations and deliberations about Continental Illinois Bank, the press reports, particularly the New York Times, indicate that Continental Illinois Corporation creditors may be made whole by the Government. Is that really true?

2. Can you give the Committee assurances that the FDIC and Fed will only be assisting the insured bank and not the holding company shareholders or creditors?

Answer:

There is apparently some misunderstanding about the effect of the FDIC transaction on the creditors of Continental Illinois Corporation ("CIC"). The creditors of Continental Bank's holding company are not insured by the FDIC and the FDIC assurances against loss for depositors and general creditors of the Continental Bank do not apply to the creditors of CIC.

After the adoption of the proposed assistance package, and under the hypothetical circumstance where the Bank would be closed, its assets liquidated, and the holding company insolvent, the CIC noteholders could be more senior to that of the FDIC as a result of the position of a preferred stockholder. In that hypothetical situation, to the extent that there is any recovery from the assets of the Bank and the holding company, these assets would probably be distributed first to the noteholders and only then to the FDIC as a preferred stockholder.

In view of the commitments of support to the Bank made by the FDIC and the Federal Reserve, it seemed that this situation was more hypothetical than real, while there were substantial practical benefits to the approach of providing equity capital to the Bank through the holding company. Indeed, adopting a different, less effective, capital structure could well have hastened the result which the banking regulators have sought to avoid. We also took into account the fact that any successful assistance program would have some incidental beneficial effect on the CIC noteholders by strengthening the Bank.

Nonetheless, careful consideration was given to the structuring of the assistance to Continental Bank in the form of a stock investment in the Bank, rather than through the intermediary of the holding company which could have avoided even the hypothetical situation described above. However, a provision in the indenture governing CIC's long-term debt, requiring that the holding company hold at least 80 percent of the capital stock of the Bank, made this course of action impossible in an open bank transaction. All of those involved on the government side in this transaction concurred in the view that an open bank transaction was important in order to maximize the possibilities for a successful rehabilitation of the Bank, minimize the cost to the FDIC, and maintain general market confidence. As noted above, we also recognized that no matter how an open bank transaction was structured, CIC's noteholders would obtain some benefit, if only because the major asset backing the holding company's debt to them -- the Bank -- would be benefited by the FDIC assistance, whatever its form.

Consideration was also given to making a subordinated debt investment in the Bank, but with warrants to holding company stock, instead of Bank stock, thus avoiding the limitations of the covenant described above. However, this alternative was also rejected by the FDIC because it could not be considered as the full equivalent of capital for either regulatory or market purposes.

The FDIC came to the conclusion that the capital infusion portion of the assistance to the Bank through the preferred stock investment in the holding company providing rights to 80 percent of the common stock, when combined with the other elements of the package that gave the FDIC important management rights and the ability to recoup losses by acquiring additional stock, was the best way of meeting these twin goals of protecting the insurance fund while providing the best opportunity for putting the Bank on a self-sustaining basis. The Board concurred in this judgment.

In reaching this judgment, careful consideration was given to the legal issues. After a full analysis, the FDIC concluded that it had the authority to take preferred stock in the holding company and downstream it to the Bank. Federal Reserve board counsel agreed with this position, as did the Office of Legal Counsel of the Justice Department.

We are concerned about bank holding company debt covenants which have the result in this case of circumscribing the ability of the FDIC to make a direct capital investment in the Bank. We are looking into whether these covenants are widespread and what their effect is with a view to taking appropriate regulatory action to limit their scope in the future. In any event, the assistance program for Continental Illinois Bank is not indicative of a policy of extending protection to holding company creditors.

As far as the Federal Reserve assistance is concerned, the only lending by the Federal Reserve that has occurred has been with the Bank and not at the bank holding company level.

3. Why did the FDIC "guarantee" all depositors, whether insured or not, in the original assistance package?

Answer:

In May, Continental Bank, following a series of events including substantial loan losses, experienced a loss of confidence in the national and international money markets where it was obtaining the preponderance of its funding. Based on all facts known then and now, the capital of the Bank was adequate to meet these losses. Action to sustain the Bank was appropriate and necessary to avoid disruption of the banking and financial system. This was done with both liquidity support and by an injection of capital by the FDIC and certain banks on a subordinated basis. Having taken this step, the FDIC had a clear interest in maintaining the Bank as an operating entity by providing an assurance of continuing operations for depositors and general creditors of the Bank. In this connection, the FDIC stated: "In view of all the circumstances surrounding Continental Illinois Bank, the FDIC provides assurance that, in any arrangements that may be necessary to achieve a permanent solution, all depositors and other general creditors of the bank will be fully protected and service to the bank's customers will not be interrupted."

4. Who else is being guaranteed in this bank that no one wants to buy?

Answer:

Other than the announced FDIC assistance package and the liquidity support being provided by the Federal Reserve, there is no other government assistance for Continental.

5. Are the Continental Illinois shareholders getting options in case the stock appreciates while the FDIC takes all the bad loans?

Answer:

The FDIC assistance package was carefully structured to provide substantial protection for the FDIC against losses and to enable it to participate in any increase in value of the Bank. The FDIC would take rights to 80 percent of the common stock of the CIC and the remaining 20 percent stake in the common stock of Continental Illinois Corporation that would be held by existing shareholders would be subject to a so-called "make whole" agreement, whereby these shares would, in effect, be turned over to the FDIC under a formula based on the amount of losses the FDIC incurs on the loans purchased from Continental Bank. Under the arrangement, if the FDIC loses $800 million on the loan purchase, all of the ownership interest in CIC held by existing shareholders would be conveyed to the FDIC, at its option, at the nominal price of $0.00001 per share. Moreover, any dividends paid by the Bank or CIC will be held subject to the make whole agreement.

The assistance package proposal also provides existing shareholders with rights to buy new stock in the Bank at an initial price of $4.50 per share -- a cost equal to the price of the FDIC's stock investment -- for a period of 60 days, or $6.00 per share during the subsequent 22 months. It should be noted, however, that these rights, if fully exercised by the shareholders, would add an additional $240 million to the common equity of CIC. Moreover, in order for the stockholders to gain on their remaining holdings of CIC stock, the FDIC would also have a gain on its much larger holdings, thus helping to offset the risk of loss borne by that agency. In this situation, it would be unlikely for the shareholders to benefit from their rights while the FDIC would be incurring losses.

6. Do you do that in small banks you close?

Answer:

Banks are closed and liquidated almost without exception only when they are insolvent -- when their liabilities exceed their assets and when circumstances combine with other severe problems, such as a very high level of contingent liabilities due to mismanagement and fraud, so as to make a purchase and assumption impossible. Considered over the history of the FDIC, bank liquidations with losses to insured depositors and creditors have not been the normal procedure for dealing with problem banks. Normally, a high value is placed on maintaining banking services regardless of the size of the bank, consistent with minimizing the cost to the insurance fund. Continental, however, was not insolvent and the shareholders maintain an equity investment with a book value of about $800 million. Consequently, the closed bank-liquidation analogy is not appropriate and the regulators have attempted in this case to take action which is functionally equivalent to a purchase and assumption with the same emphasis on maintaining banking services while minimizing the cost to the FDIC.

When a bank is closed, small or large, any recovery to the shareholders depends on whether there is any value remaining after claims have been settled. The assistance package arrangement whereby the FDIC obtains rights to 80 percent of the banking organization with the further provision that existing shareholders would, depending on FDIC's losses, lose an amount up to their entire investment if the FDIC sustained losses, was designed to ensure, to the extent practicable, an equitable distribution of risk between the shareholders and the FDIC. In the Continental case, the analogy to a closed bank purchase and assumption transaction is relevant in the situation where the FDIC would suffer $800 million of losses on the basket of loans acquired, and the assistance package deals with this situation in a manner similar to that applicable to closed banks in as much as the shareholders would lose all of their existing investment in CIC.

7. Are the Continental Illinois Corporation commercial paper holders getting an FDIC guarantee?

Answer:

No. All of the commercial paper of CIC, from a peak of approximately $2 billion on June 30, 1982 (except for $20.3 million) has been repaid from the resources of CIC. Moreover, the FDIC has made it quite clear that its assurances do not extend to the bank holding company or any of its subsidiaries.

8. Is the FDIC or the Federal Reserve guaranteeing that all of the bondholders of Continental Illinois get paid?

Answer:

See response to Question 1.

9. If they are, why did the Federal Government resist providing these types of guarantees to electric utility bondholders on Long Island or in New Hampshire? Is this consistent?

Answer:

As you know, a safety net protecting the liquidity of depository institutions has long been an established element of public policy. Federal assistance has been directed to Continental Bank; any benefits for its holding company were incident to, and inherent in, protecting the Bank.

10. Critics of granting new powers to depository institution holding companies continue to assert that the problems of Continental Illinois Bank argue against the granting of new securities powers and/or other new powers. What is your opinion of these arguments?

Answer:

The problems of Continental Bank essentially reflect serious weaknesses in the domestic loan portfolio of a bank that had engaged in aggressive growth and lending practices for some time, including heavy involvement and participation in energy loans of the Penn Square bank that failed two years ago. These problems, and other credit losses, were reflected in earnings pressures and consequent loss of market confidence. The problems of the Bank clearly did not arise from the nonbanking activities of the holding company and, in fact, the holding company was able to assist the banking enterprise as a whole in meeting its problems.

We do not believe the problems of the Continental Illinois Bank argues against granting new powers to bank holding companies that can be exercised in a safe and sound manner while providing consumers with the benefits of competitive and convenient services. We would be concerned if the additional powers added substantial risk to the banking structure as a whole, and this has been a major concern of the Board during the long and careful review of the proposed legislation. The new powers that are provided -- revenue bond underwriting, discount brokerage, underwriting and dealing in commercial paper and in residential mortgage-backed securities -- are comfortably within the scope of risks that can be appropriately taken by bank holding companies. The legislation now before the Senate provides a framework which will help assure that these activities are conducted within the bounds of safe and sound financial practices. We put particular emphasis on the structure of the bill which emphasizes capital adequacy and provides the Board with sufficient authority to establish the terms, conditions and limitations on which these activities may be conducted.

Because of the close links between the fortunes of a bank holding company and its subsidiary banks that are demonstrated in the Continental situation, we would be concerned about any weakening of these safeguards. We are, in fact, concerned about the increasing authorization of activities for banks by the states that would not, at the federal level, appear to be suitable for these institutions on safety and soundness grounds and would not be authorized by Congress for this reason.

The Continental experience also demonstrates the importance of adhering to time tested prudent principles of banking, and that the inherent risks in this vital business must be protected against with adequate capital, ample liquidity and diversification of risk.

Responses by Chairman Volcker to the written questions
from Senator Mattingly in connection with the hearing
on July 25, 1984.

1. Chairman Volcker, I agree with your view that we should expect and encourage adjustment in our external accounts in the future. However, I am concerned that you might leave the wrong impressions that we are attracting vast new sums of capital from abroad. Isn't it actually true that the improvement in our capital accounts is the result of reduced bank lending, rather than more funds from abroad? Therefore, we aren't attracting new foreign capital.

Answer: The growth of the U.S. current account deficit since 1982 has been accompanied by a sharp reversal in the net flow of funds from U.S. banks to foreigners. In a fundamental sense, the substantial current account deficit indicates that we are consuming and investing more than we are producing. The financial counterpart to this deficit is a net capital inflow from the rest of the world. This inflow takes a variety of forms, both recorded and unrecorded. It is important, but from the overall points of view secondary, whether this net capital inflow is the result of an increase in U.S. liabilities to foreigners or a reduction in U.S. claims on foreigners. Looking simply at the amount of credit available to U.S. residents, a shift in U.S. banks' lending from foreign to U.S. residents has close to the same impact as an inflow of new foreign capital accompanied by no change in bank lending to foreigners.

From other standpoints -- including the question of cause and sustainability -- I agree the composition can be important. While data in this area must be interpreted cautiously -- there is, for example, a large statistical discrepancy -- you are right in attributing much of the swing to reduced bank lending (or depositing) abroad, presumably in response to changes in relative demands as well as the LDC problem. However, there also appears to be sizable continuing inflows of funds originating abroad.

2. The Fed's economic projections in Table I of your testimony have economic growth settling down to about 3% in 1985 with about 5-1/2% inflation.

However, the economy has the potential to grow faster than the long-run trend until full employment is reached, perhaps not until 1987.

If the economy grows faster than 3% without inflation pressure, will the FOMC tend to restrict money growth to slow the economy? Isn't it true that long-run economic growth is determined by factors other than monetary policy?

Answer. No one can be certain how much unused capacity remains in our economy and how much longer rapid economic expansion can persist before we encounter a resurgence of inflationary pressures. The forecasts presented in my testimony represent the best judgments of FOMC members as to economic growth and price movements next year, given underlying economic conditions, the likely stance of fiscal policy, and their decision on monetary policy. A more favorable outcome, in which our economy proved capable of sustaining more rapid economic expansion for some time without generating a pick up of inflation, would be most welcome. Such an outcome could be accommodated comfortably within the monetary growth ranges announced for next year, and the economy then would not only reach a higher potential sooner, but the price performance would be a favorable harbinger for sustaining orderly growth. I do believe it important that we approach our potential without generating a renewed inflationary process -- and indeed with the possibility of making further progress toward our longer-term objective of stable prices -- so that we can enjoy a prolonged period of stable growth at full employment.

I agree that monetary policy does not itself determine the long-run growth of the economy. Rather, the growth of potential output depends on expansion of the labor force and capital stock, and on gains in the efficiency with which labor and capital work together -- that is, productivity. The principle role of monetary policy is to foster stable financial and economic conditions conducive to sustained growth at a high level. However, the long-run growth of the economy can be affected by the way monetary and fiscal policy interact in pursuit of this objective. One of my principle concerns with our current and prospective federal budget stance is that by absorbing a large proportion of the supply of private saving and keeping interest rates relatively high, the deficits will tend to discourage capital investment and thereby constrain the long-run growth of the economy.

ANSWERS TO QUESTIONS SUBMITTED BY
SENATOR TRIBLE

1. As the primary regulator of bank holding companies, what role is the Fed playing in the rescue of Continental Illinois?

As a matter of general background, problems arose out of the loan losses of the Continental Illinois Bank and its holding company -- Continental Illinois Corporation ("CIC") -- was able to provide some assistance to the banking organization as a whole in meeting the problems resulting from the Bank. From its perspective as holding company supervisor, the Federal Reserve has monitored the condition of the CIC and the role it has played in assisting the Bank. In particular, beginning in July 1982, the Federal Reserve Board staff, as well as the staff of the Federal Reserve Bank of Chicago ("FRBC") very closely monitored the operations of CIC and its subsidiaries, as well as the progress of the Bank.

The Board obtained periodic reports (either weekly or daily) regarding the funding of CIC, the maturity of its liabilities, major sources of funds, asset composition, trends in stock market prices, Federal Reserve borrowing, and interbank activity. The Board and the Reserve Bank staff also consulted periodically on numerous occasions with the national bank examiners for the Bank. In addition, during this period, the Federal Reserve conducted two full inspections of CIC. The

Federal Reserve in Washington and in Chicago held numerous meetings with the senior management and directors of CIC to discuss their situation and funding needs and obtain frequent progress reports regarding their operating results and success in meeting projections. The Fed also monitored transfers of assets between CIC and its banking and nonbanking subsidiaries. Prior to May 9 of this year, the Federal Reserve assisted the Office of the Comptroller of the Currency in the final examination of the Bank and conducted an independent analysis of the value of CIC's assets. As part of the assistance package, the Federal Reserve has entered into a written agreement with CIC requiring it to establish a plan to reduce the consolidated assets at Continental to a level that can be funded on a sustainable basis.

Since the problems of the Bank became apparent, the Federal Reserve has counseled with other federal agencies on dealing with the Bank's problems and has participated in the formulation of the May 17, 1984 temporary assistance package and in the arrangements for permanent assistance announced on July 26, 1984. In addition, the Federal Reserve has been called upon for substantial discount window assistance by the Bank, and in this connection, has carefully monitored the Bank's activities, again in full cooperation with the Comptroller and the FDIC.

2. The Chicago Federal Reserve Bank is making loans to Continental through the "discount window."

   a. How large are these loans?

Discount borrowing by all depository institutions are disclosed weekly by the Board and borrowings by Federal Reserve Districts are announced weekly for each Wednesday which is the end of the statement week. Total borrowings for the week ending on August 8, 1984 were $7.3 billion, and for the Chicago District, discount window loans amounted to $6.8 billion. The Chicago District amount very closely approximates the discount window borrowing by Continental Illinois Bank. The amount has varied from time to time, but the August 8 figure is the highest weekly amount that has been outstanding for this institution.

   b. What interest rates do they carry?

The discount window loan by the Federal Reserve Bank of Chicago to Continental Illinois Bank now carries an interest rate of 11 percent. Under regulations established by the Board, the extended credit borrowing by the Bank normally carries an interest rate based on the discount rate, now at 9 percent, plus a gradually increasing surcharge that raises the applicable interest rate by a total of two percent at the end of five months. In the case of Continental, this schedule was accelerated. The initial nine percent rate was increased to 10 percent within thirty days, and to 11 percent within another thirty days. It is intended that this rate will be adjusted from time to time so that it remains in line with market rates.

c. How do these interest rates compare to rates which private lenders would charge for the same loans?

The comparable interest rate would be the rate paid by depository institutions of comparable size for certificates of deposit. The 3-month CD rate on August 3, 1984 as compiled by the Federal Reserve Bank of New York was 11.3 percent. The federal funds rate, a measure of cost of funds for overnight borrowing by large banks, was around 11.5 percent on that date.

d. What subsidy is being conveyed to Continental by these loans?

As noted above, the rate being applied to this loan is based on the discount rate which is now nine percent to which a 2 percent surcharge is applied. Also as noted above, this 11 percent rate is reasonably close to the prevailing CD rate, and it is intended that the surcharge would be adjusted from time to time to maintain a close approximation of the rate charged on the discount window loan to market rates.

3. The Fed apparently will lend money to the FDIC to allow that agency to purchase "troubled loans" from Continental.

a. What terms will these loans carry?

In an arrangement that is similar to three prior cases, as part of the fundamental restructuring of Continental Bank, the FDIC is assuming Continental's obligation to repay a portion of the discount window assistance by the Federal

Reserve. Similar arrangements were adopted in the case of the Franklin National Bank in 1974, the Greenwich Savings Bank in 1981, and the First National Bank of Midland in 1983.

Under the agreement, the FDIC would assume $3.5 billion of the indebtedness of Continental Bank to the Federal Reserve Bank of Chicago. The FDIC would be required to make quarterly interest payments. The FDIC would also be required to use collections (net of the cost of collection) from the loans and claims acquired from the Bank to make payments of interest and principal. Any remaining principal would be paid by the FDIC at the end of five years.

The interest rate applicable to $2 billion of the indebtedness would be the three-month Treasury bill rate plus 25 basis points. The interest rate applicable to the remaining $1.5 billion of indebtedness would be the rate determined by the FRBC to be applicable to advances from the FRBC to the Bank. As the Bank exercises its option over time to transfer additional loans to the FDIC, the amount of FDIC indebtedness subject to the former interest rate would be increased by the amount of loans sold, and the amount of FDIC indebtedness subject to the latter interest rate would decrease by the same amount.

b. What is the expected budgetary cost of the FDIC loan purchases?

The budgetary aspects of the loan purchases are a matter within the particular expertise of the FDIC and would be most appropriately addressed by that agency.

c. Will these costs be reflected in the unified federal budget, or will they be "off-budget"?

The same referral to the FDIC would also be appropriate for this question.

d. What subsidy will Continental get from selling its loans to the FDIC (rather than to the market)? That is, what will it cost the government to buy "troubled loans" at book value, rather than at (discounted) market value?

A portion of the loans to be purchased by the FDIC will be marked-down substantially from their book value. The FDIC intends to purchase loans with a May 31, 1984 book value of $3.0 billion (face value of over $3.6 billion) for a price of $2 billion -- an initial discount of approximately 45 percent. In addition, the Bank has the right for a three-year period to select other loans outstanding on May 31, 1984 with a book value of $1.5 billion and sell them to the FDIC for $1.5 billion. If the FDIC purchases the full amount of loans provided for under the agreement, the discount will amount to approximately 32 percent. This arrangement, plus the so-called "make whole" provisions of the arrangement which allows the FDIC to recoup up to an additional $800 million of any losses on these loans, is calculated to minimize the possibility of losses to the FDIC as a result of the loan purchases.

4. The Fed was represented on the Chrysler loan Guarantee Board. One of the elements of the Chrysler bailout was the government's receipt of warrants to buy Chrysler stock, which ultimately reduced the cost of the rescue.

   Have any federal regulators considered similar warrants from Continental in exchange for federal assistance?

The FDIC will receive, subject to shareholder approval, preferred stock which is convertible into 160 million shares or approximately 80 percent of Continental Illinois Corporation's common stock. In addition, as noted above, the FDIC, if it suffers losses on the purchased loans, would have the right to the remaining 20 percent of the stock of the Corporation. It should also be noted that the government more than covered the costs of its participation in the Chrysler loan guarantee program. As in the case of Chrysler, the government is in a position to benefit from any increase in the value of the shares of the Corporation.

Would the Fed recommend such warrants? If not, why not?

The Federal Reserve strongly supported the arrangements which provided convertible preferred stock to the FDIC so that it could participate in any gains in value of the corporation to compensate for the risks taken in the assistance package.

5. What steps are being taken to minimize the cost of the Continental rescue to government and taxpayers?

The arrangements described above indicate the substantial protections that the government has obtained to protect its position and to allow it to participate in any increase in value of the corporation. The convertible preferred stock, the "make whole," and the various covenants, including those which provide the FDIC with certain essential management rights, assure that the costs of this assistance package are minimized, and provide for the possibility of financial gains. It is also important to note that to the extent there are any costs to the FDIC of the assistance package, they are borne by the insurance fund, which is made up of insurance premiums paid by insured banks.

6. The proposed Continental rescue has been described as "effective nationalization" of the bank. Do you think that is an accurate description? If not, why not?

It is the intention of the agencies to create a viable, independent bank positioned to continue providing the full range of services to its customers, particularly those throughout the midwest. The FDIC has stated that it will not interfere with or control the bank's day-to-day operations and that it will not control the hiring or compensation of officers, lending or investment policies or other normal business decisions. For these reasons, the assistance package is not an "effective nationalization" and it is not intended that it should be. Rather, as soon as practicable, the FDIC has stated that it intends to dispose of its stock interest in CIC through the sale to a private investor group, to one or more banking organizations or to the public in an underwritten offering. It should be emphasized, of course, that the Continental Illinois banking organization will be subject to supervision and regulation by the Comptroller of the Currency and the Federal Reserve.

FEDERAL RESERVE'S SECOND MONETARY POLICY REPORT FOR 1984

TUESDAY, JULY 31, 1984

U.S. Senate,
Committee on Banking, Housing, and Urban Affairs,
Washington, DC.

The committee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Jake Garn (chairman of the committee) presiding.

Present: Senators Garn, Heinz, Hecht, and Humphrey.

OPENING STATEMENT OF CHAIRMAN GARN

The Chairman. The committee will come to order.

We're continuing today our semiannual hearings on the conduct of monetary policy.

Last week we had the pleasure of hearing the Chairman of the Federal Reserve Board, Paul Volcker. This morning, we have the pleasure of hearing outside witnesses and witnesses from the administration.

First, we're very happy to have William Poole before us this morning. He'll be the first witness.

Before you start, Senators, do you have any comments you wish to make?

[No response.]

The Chairman. Mr. Poole, please go ahead.

STATEMENT OF WILLIAM POOLE, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. Poole. Senator Garn, thank you very much. I am certainly pleased to be here this morning to testify before this committee on the midyear review of monetary policy.

My statement—and I'll read parts of it—is divided into two major sections. The first, is on the economic expansion to date, and the second is on the economic outlook.

My primary purpose is to examine the economic setting within which present monetary policy decisions must be made rather than to examine the details of monetary policy itself. The policy details are very important, but many will fall into place rather naturally if the underlying policy setting is properly conceived.

PRESENT ECONOMIC EXPANSION

Let's look at the economic expansion so far. The principal facts of the vigorous recovery following the recession trough in the fourth quarter of 1982 are well known. In short, we have enjoyed rapid output growth, declining unemployment, and declining inflation. The controversial topic is not what has happened but why it happened. The explanation most often offered is that the economic expansion has been driven by "massive"—in quotes—Federal deficits. But others have expressed the view that the deficit will abort the recovery. In my opinion Federal fiscal policy has played a very important role, but the deficit per se has not been especially important in either driving or restraining this expansion.

Before turning to monetary policy I'll begin with comments on fiscal policy. A key starting point to the analysis of fiscal policy is that while the budget deficit is important for many purposes, it is an inadequate summary measure of the impact of fiscal policy on the economy. The source of the deficit and of changes in it can make an enormous difference. Changes in Government spending have different effects from changes in taxes, and the nature of any spending or tax changes affects the final result.

In the present circumstances, the importance of these general considerations can be seen quite easily.

Suppose this administration in 1981 had embarked on a program involving a major expansion of a wide range of spending programs instead of pursuing a program of tax reductions and expenditure restraint. Suppose also that the budget deficits in this alternative fiscal policy had turned out to be about the same as the budget deficits actually realized so far. Would the economy's performance been the same as that actually realized?

A negative answer is unambiguously the correct one. The investment boom we are now enjoying would not have occurred. The size and importance of this investment boom are insufficiently appreciated by many analysts. Since the recession trough, real business fixed investment has increased by an unusually large magnitude, a magnitude more than double the typical contribution of business fixed investment to real GNP growth over the first six quarters of recovery. Indeed, in the second quarter of this year, real business fixed investment as a share of real GNP was higher than for any other quarter for which we have quarterly data since World War II.

Table I, attached at the end of my statement, provides some additional detail on the composition of output during this expansion. The first line of the table shows the growth of real GNP at a percent annual rate from 1982 fourth quarter to 1984 second quarter. In this expansion real GNP has grown at a 7.2-percent annual rate compared to a 5.9-percent annual rate over a comparable period for a typical expansion. The importance of business fixed investment to the present expansion shows up in line 3 of the table. This component has contributed 1.8 percentage points to real GNP growth this time compared to 0.7 percentage point in a typical expansion.

Rates of return and investment opportunities in the United States have improved dramatically over the last 4 years, and the result is not only the investment boom at home but also an inflow of capital from abroad and a strong dollar. Neither would have occurred without confidence in the future of the U.S. economy.

So far I have said nothing about monetary policy, which is the focus of these hearings. Monetary policy has made an important contribution to the results we are observing. Without monetary restraint from 1979 to mid-1982 the rate of inflation would not have declined significantly. The Federal Reserve and the administration have both emphasized that a disciplined monetary policy is essential to achieving the goal of full price stability, a goal all of us share.

Now let me examine the outlook over the next few years and longer. When all the evidence is in we may find that money growth from mid-1982 to mid-1983 was too high. The future course of the economy will depend partly on how the economic processes already underway work themselves out, but future monetary and fiscal policies will be more important. As for fiscal policy, no one disputes the necessity of bringing the budget deficit down over time; however the outlook depends very importantly on how the deficit is reduced. The emphasis in deficit reduction should be on controlling Federal spending. Tax increases rolling back the incentives for the private economy to invest and grow would not be constructive.

The present investment boom is highly relevant to assessing the feeling—I emphasize that it's a feeling—of numerous analysts that this business cycle expansion is too good to last. Some analysts believe that our economy's good news is really bad news.

Before digging into this good news is bad news feeling, let me say that I know that the time will come when some or many of the incoming economic statistics may appear less favorable. A few bad numbers will trigger stories that the bad news is arriving, but I want to emphasize the need for a sense of historical perspective and for attention to the economic fundamentals that lie behind the monthly outpouring of economic statistics.

The investment boom and its determinants are one of the fundamentals that must be emphasized when analyzing the good news is bad news argument.

RAPIDLY RISING TO CAPACITY

Part of that argument is that we are rapidly pressing up to capacity in certain industries and that these industries will soon become bottlenecks setting off a new round of inflation. Certain industries will, indeed, become bottlenecks unless they add additional capacity to produce the goods rising in demand.

Table 2 at the end of my statement suggests that investment is, in fact, being put in place in industries operating at relatively high capacity utilization rates. For example, for durable manufacturing as a whole, firms presently plan a 18.6-percent increase in investment expenditures in 1984 compared to 1983. But within the durable manufacturing category, the electrical machinery industry has planned 1984 investment that is 23½ percent greater than in 1983, reflecting the fact that the industry is now operating at a capacity utilization rate above its 1978–80 peak. Conversely, the steel, stone, clay, and glass industries expect 1984 investment spending to be about 9½ percent above the previous year, reflecting the fact that in these industries the present level of capacity utilization is well below prior peaks.

In addition to the protection from bottlenecks afforded by the investment boom, the U.S. economy at present can call on idle capacity abroad. The economic recovery in Europe has been less vigorous than ours. Substantial excess capacity exists in many industries. One reason that maintaining open markets internationally is important to all of us is that international trade provides a mechanism for relieving bottleneck and inflation pressures, should they arise. And the efficiencies can be enormous. It obviously makes no sense to build capacity in the United States behind artificial trade barriers when there is idle capacity abroad, just as it would make no sense to build more capacity in a particular industry located in California because some artificial trade barrier prevented idle capacity in New York from being put back to work.

This argument, of course, is completely symmetrical. As can be seen from line 5(a) in table 1, U.S. exports have been rising since the recession trough. This fact is a surprise to many who have assumed that the strong dollar is pricing U.S. goods out of foreign markets. As the recovery abroad picks up momentum, U.S. exports should grow even more rapidly, promoting additional employment in the United States and continued growth in U.S. labor productivity.

As with my earlier discussion, this analysis may seem to ignore monetary policy. Let me now emphasize that our excellent investment climate depends as much on monetary policy as on fiscal policy. The spur to investment from the Economic Recovery Tax Act of 1981 [ERTA], depends importantly on low inflation. The real value of depreciation allowances in the tax law depends on the rate of inflation which, in turn, depends primarily on monetary policy. It is no accident that in the late 1970's investment tended to flow in directions other than to business fixed investment. With higher inflation, the use of original cost depreciation in the tax laws made business investment less profitable than it had been in the 1960's. In the late 1970's, our investment increasingly went abroad, into land and housing, into precious metals, collectibles, and so forth. The combination of lower inflation and ERTA has restored the incentive for business investment.

LOWER INFLATION INSPIRES CONFIDENCE

As important as is the measurable effect of lower inflation, a much less tangible effect, rising confidence, is also at work. Inflation engenders a climate of uncertainty, fears of abrupt changes in monetary and fiscal policy and of wage, price, and credit controls. Monetary policy, and expectations about future monetary policy, play the key role here. Today's investment boom is a vote of confidence that inflation will remain low in the immediate future.

Table 3 provides survey evidence on inflation expectations in the United States. The top part of the table reports near-term inflation expectations in the fourth quarter of each year from 1968 through 1977. The bottom part of the table reports both near-term and longer term expectations for most quarters since 1978, picking up data on 10-year inflation expectations from a survey started in 1978.

Since 1980, the one-quarter and 1-year inflation expectations have declined dramatically, more or less in line with the decline in the actual inflation rate, but the average annual rate of inflation expected over 10 years has not declined nearly as much. Despite the dramatic decline in actual inflation over the last few years, the deep 1981-82 recession, and the vigorous recovery accompanied by further declines in inflation, the 10-year inflation expectation only fell from about 8½ percent to about 6½ percent. That means that as of today the price level is expected to almost double over the next decade.

Why should investors fear an average inflation rate of this magnitude? A little history is needed for perspective here. The rising inflation from 1965-80 was interrupted by several unsuccessful control efforts. Comprehensive wage and price controls introduced in 1971 failed. Tighter monetary and fiscal policies and the 1973-75 recession had no lasting effect. After these episodes and others, why should investors believe that the inflation battle is now won, just because the present rate of inflation is low?

Previous efforts to control inflation failed principally because monetary policy discipline was relaxed. The problem was not that monetary policy failed to work as advertised, but that it worked all too well. Inflationary expansions of money growth did, in fact, cause inflation.

It would be foolish of me to say that it could never happen again. With the wrong policies, of course it could happen again. Given the false starts over the 1965-80 period it is not surprising that the market is skeptical; however, no one should underestimate the determination of the administration and the Federal Reserve to pursue noninflationary policies.

What precisely is a noninflationary monetary policy? In my view, the policy announced by the Federal Reserve in its midyear report is appropriate. I am pleased to see the renewed emphasis on M1 as a monetary policy target. I am pleased to see the M1 target range for next year have an upper limit of 7 percent growth, reduced from this year's 8 percent upper limit. And I am pleased to see a more narrow range for M1 growth for next year, a 3-percentage-point range from 4 to 7 percent growth. I hope that in future years the Federal Reserve will go even further in the same direction in each of these policy dimensions.

A monetary policy emphasizing maintenance of steady money growth within gradually declining money growth targets and a fiscal policy emphasizing incentives for saving, investment, and growth will work. As these policies are continued, a time will eventually come when market participants will realize that inflation will not average 6 percent over the next decade. When that happens, market interest rates will fall, perhaps dramatically.

Now a brief concluding comment. I have sought to emphasize that the vigorous expansion now in progress should not be greeted with a good news is bad news reaction. Although intuition should not be ignored, a vague feeling that there's trouble ahead is not a good reason to change monetary and fiscal policy. There should be no attempt to fine tune policy in response to wiggles in monthly and quarterly data. Concentration on policy fundamentals is what is needed: A progrowth fiscal policy with a declining budget deficit and a disciplined monetary policy characterized by gradually declining money growth.

If we, in Government do our job, private economy will take care of itself very nicely, indeed.

Thank you.

[The complete statement follows:]

STATEMENT
OF
WILLIAM POOLE
MEMBER
COUNCIL OF ECONOMIC ADVISERS

I am very pleased to have this opportunity to testify before this Committee on the Midyear Review of Monetary Policy.

My statement is divided into two major sections, the first on the economic expansion to date, and the second on the economic outlook. My primary purpose is to examine the economic setting within which present monetary policy decisions must be made rather than to examine the details of monetary policy itself. The policy details are extremely important, but many will fall into place rather naturally if the underlying policy setting is properly conceived.

THE ECONOMIC EXPANSION TO DATE

The principal facts of the vigorous recovery following the recession trough in the fourth quarter of 1982 are well known. In short, we have enjoyed rapid output growth, declining unemployment, and declining inflation. The controversial topic is not what has happened but why it happened. The explanation most often offered is that the economic expansion has been driven by "massive" Federal deficits. But others have expressed the view that the deficit will abort the recovery. In my opinion, Federal fiscal policy has played a very important role, but the deficit *per se* has not been especially important in either driving or restraining this expansion.

Before turning to monetary policy I'll begin with some comments on fiscal policy. A key starting point to the analysis of fiscal policy is that while the budget deficit is important for many purposes it is an inadequate summary measure of the impact of fiscal policy on the economy. The source of the deficit and of changes in it can make an enormous difference. Changes in government spending have different effects from changes in taxes, and the nature of any spending or tax change affects the final result.

In the present circumstances the importance of these general considerations can be seen quite easily. Suppose this Administration in 1981 had embarked on a program involving a major expansion of a wide range of spending programs instead of pursuing a program of tax reductions and expenditure restraint. Suppose also that the budget deficit from this alternative fiscal policy had turned out to be about the same as the budget deficit actually realized so far. Would the economy's performance have been the same as that actually realized?

A negative answer is unambiguously the correct one. The investment boom we are now enjoying would not have occurred. The size and importance of this investment boom are insufficiently appreciated by many analysts. Since the recession trough in 1982:IV real business fixed investment has increased by an unusually large magnitude--a magnitude more than double the typical contribution of business fixed investment to real GNP growth over the first six quarters of recovery. Indeed, in the second quarter of this year real business fixed investment as a share of real GNP was higher than for any other quarter for which we have quarterly data since World War II.

Table 1 provides some additional detail on the composition of output during this expansion. The first line of the table shows the growth of real GNP at a percent annual rate from 1982:IV to 1984:II. In this expansion real GNP has grown at a 7.2 percent annual rate compared to a 5.9 percent annual rate over a comparable period for a typical expansion. Six major components of real GNP are reported in the table; the entries on lines numbered (1) through (6) add up to total real GNP growth. Selected subcomponents are also reported. The importance of business fixed investment to the present expansion shows up in line (3) of the table; this component has contributed 1.8 percentage points to real GNP growth this time compared to 0.7 percentage points in a typical expansion.

Another striking feature of this expansion is the net export balance. Many analysts have interpreted the decline in net exports as a troublesome aspect of this recovery. While it is certainly true that the rapid growth of imports has produced some dislocations in import-competing industries, the rising capital flow to the United States--the counterpart to the declining net export balance--is a clear sign that investors have tremendous confidence in the U.S. economy. The strong dollar is another sign of this confidence.

In short, rates of return and investment opportunities in the United States have improved dramatically over the last four years, and the results include an investment boom at home, an inflow of capital from abroad, and a strong dollar. None of these would have occurred without confidence in the future of the U. S. economy.

So far I have said nothing about monetary policy, which is the focus of these hearings. Monetary policy has made an important contribution to the results we are observing. Without monetary restraint from late 1979 to mid 1982 the rate of inflation would not have declined significantly. The Federal Reserve and the Administration have both emphasized that a disciplined monetary policy is essential to achieving the goal of full price stability--a goal all of us share.

I would be remiss, however, if I did not point out that the high rate of money growth from the summer of 1982 to the summer of 1983 was important in propelling the economy forward over the last six quarters. But policy-makers in the Federal Reserve and the Administration recognized that M1 money growth from mid 1982 to mid 1983 was unsustainably high. In response, money growth was reduced in the second half of 1983 and M1 has remained within its 4 to 8 percent target range in 1984. Also, M1 growth has been reasonably steady. These are constructive developments.

THE ECONOMIC OUTLOOK

When all the evidence is in we may well find that money growth from mid 1982 to mid 1983 was too high; the future course of the economy will depend partly on how the economic processes already underway work themselves out. But future monetary and fiscal policies will be more important than the lagged effects of past policy actions. As for fiscal policy, no one disputes the necessity of bringing the budget deficit down over time. However, the outlook depends very importantly on how the deficit is reduced. The emphasis in deficit reduction should be on controlling Federal spending; tax increases rolling back the incentives for the private economy to invest and grow would not be constructive.

Private investment spending is important not primarily as a direct stimulus to job creation--jobs can also be created in industries producing consumption goods--but rather as a necessary ingredient to the economic growth process. In the long run the economy cannot grow without more productive capacity. Moreover, the application of new technology from the lab requires that new kinds of capital goods actually be built and placed in service. The end result is growing output, growing labor skills and productivity, and a higher standard of living.

The present investment boom is highly relevant to assessing the feeling--and it is a "feeling"--of numerous analysts that this business cycle expansion is too good to last. Some analysts believe that our economy's good news is really bad news.

Before digging into this "good news is bad news" feeling let me say that I know that the time will come when some or many of the incoming economic statistics may appear less favorable. A few bad numbers will trigger stories that the bad news is arriving. But I want to emphasize the need for a sense of historical perspective and for attention to the economic fundamentals that lie behind the monthly outpouring of economic statistics.

The investment boom and its determinents are one of the fundamentals that must be emphasized when analyzing the "good news is bad news" argument. Part of that argument is that we are rapidly pressing up to capacity in certain industries, and that these industries will soon become bottlenecks setting off a new round of inflation.

Certain industries will indeed become bottlenecks unless they add additional capacity to produce the goods rising in demand. Table 2 suggests that investment is in fact being put in place in industries operating at relatively high capacity utilization rates. For example, for durable manufacturing as a whole firms presently plan an 18.6 percent increase in investment expenditures in 1984 compared to 1983. But within the durable manufacturing category the electrical machinery industry has planned 1984 investment that is 23.5 percent greater than in 1983 reflecting the fact that the industry is now operating at a capacity utilization rate above its 1978-80 peak. Conversely, the steel and the stone, clay, and glass industries expect 1984 investment spending to be 9.6 percent and 9.5 percent, respectively, above 1983 levels, reflecting the fact that in these industries the present level of capacity utilization is well below prior peaks.

A careful study of this table reveals some apparent anomolies. Some of these may be explained, in part, by other considerations. Planned 1984 investment in the motor vehicles industry is up sharply over 1983 even though present capacity utilization does not appear especially high. However, production facilities for large cars are presently working at capacity. Looking farther down the table, utilities investment appears weak even though capacity utilization at present, at 85.8 percent, is only slightly below the 1973-80 peak of 86.8 percent. This apparent anomoly is explained by the fact that there has been excess capacity in this industry ever since the first oil shock raised energy prices and reduced energy consumption. The present utilities industry capacity utilization rate is far below the 94.9 percent peak in 1973.

In addition to the protection from bottlenecks afforded by the investment boom, the U. S. economy at present can call on idle capacity abroad. The economic recovery in Europe has been less vigorous than ours; substantial excess capacity exists in many industries. One reason that maintaining open markets internationally is important to all of us is that international trade provides a mechanism for relieving bottleneck and inflation pressures should they arise. And the efficiencies can be enormous. It obviously makes no sense to build capacity in the United States behind artificial trade barriers when there is idle capacity abroad just as it would make no sense to build more capacity in a particular industry located California because some artificial trade barrier prevented idle capacity in New York from being put back to work.

This argument is, of course, completely symmetrical. As can be seen from line (5a) in Table 1, U.S. exports have been rising since the recession trough in 1982:IV. This fact is a surprise to many who have assumed that the strong dollar is pricing U.S. goods out of foreign markets. As recovery abroad picks up momentum, U.S. exports should grow even more rapidly, promoting additional employment in the United States and continued growth in U.S. labor productivity.

As with my earlier discussion this analysis may seem to ignore monetary policy. Let me now emphasize that our excellent investment climate depends as much on monetary policy as on fiscal policy. The spur to investment from the Economic Recovery Tax Act of 1981 (ERTA) depends importantly on low inflation. The real value of depreciation allowances in the tax law depends on the rate of inflation which, in turn, depends primarily on monetary policy. It is no accident that in the late 1970s investment tended to flow in directions other than to business fixed investment. With higher inflation the use of original cost depreciation in the tax law made business investment less profitable than it had been in the 1960s. In the late 1970s, our investment increasingly went abroad, into land and housing, into precious metals, collectables, etc. The combination of lower inflation and ERTA has restored the incentive for business investment.

As important as is the measurable effect of lower inflation, a much less tangible effect--rising confidence--is also at work. Inflation engenders a climate of uncertainty--fears of abrupt changes in monetary and fiscal policy and of wage, price, and credit controls. Monetary policy, and expectations about future monetary policy, play the key role here. Today's investment boom is a vote of confidence that inflation will remain low in the immediate future.

I have emphasized the importance of inflation control in maintaining an environment conducive to stable real growth. That is, general price stability is not only desirable in its own right but also because it is so important to growth in real output and employment. Unfortunately, the evidence suggests that the market does not believe that the inflation battle has been won permanently.

Table 3 provides survey evidence on inflation expectations in the United States. The top part of the table reports near-term inflation expectations in the fourth quarter of each year from 1968 through 1977. The bottom part of the table reports both near-term and longer-term expectations for most quarters since 1978, picking up data on ten-year inflation expectations from a survey started in 1978.

As a digression, I might point out that survey evidence is generally less reliable than evidence derived from actual market trading. Market evidence on inflation expectations is available in the United Kingdom from the trading of inflation-indexed government bonds. No such market evidence is available in the U. S. and so we must rely instead on survey evidence.

Since 1980 the one-quarter and one-year inflation expectations have declined dramatically, more or less in line with the decline in the actual inflation rate. But the average annual rate of inflation expected over ten years has not declined nearly as much. (Unfortunately, this survey of ten-year inflation expectations only started in 1978 and so it is not possible to compare the recent decline with the decline in ten-year expectations that must have occurred in the mid 1970s.) Despite the dramatic decline in actual inflation over the last few years, the deep 1981-82 recession, and the vigorous recovery accompanied by further declines in inflation, the ten-year inflation expectation only fell from about 8.5 percent to about 6.5 percent. That means that as of today the price level is expected to almost double over the next decade. Why should investors fear an average inflation rate of this magnitude?

A little history is needed for perspective here. The rising inflation from 1965 to 1980 was interrupted by several unsuccessful control efforts. Comprehensive wage and price controls, introduced in 1971, failed. Tighter monetary and fiscal policies and the 1973-75 recession had no lasting effect. After these episodes, and others, why should investors believe that the inflation battle is now won, just because the present rate of inflation is low?

Previous efforts to control inflation failed principally because monetary policy discipline was relaxed. The problem was not that monetary policy failed to work as advertised, but that it worked all too well. Inflationary expansions of money growth did in fact cause inflation.

It would be foolish of me to say that it could never happen again. With the wrong policies of course it could happen again. Given the false starts over the 1965-80 period it is not surprising that the market is skeptical. However, no one should underestimate the determination of the Administration and Federal Reserve to pursue noninflationary policies.

What precisely is a "non-inflationary monetary policy"? In my view the policy announced by the Federal Reserve in its Midyear Report is appropriate. I am pleased to see the renewed emphasis on M1 as a monetary policy target. I am pleased to see the M1 target range for next year have an upper limit of

7 percent growth, reduced from this year's 8 percent upper limit. And I am pleased to see a more narrow range for M1 growth for next year--a three percentage point range of 4 to 7 percent growth. I hope that in future years the Federal Reserve will go even further in the same direction in each of these policy dimensions.

A monetary policy emphasizing maintenance of steady money growth within gradually declining money growth targets and a fiscal policy emphasizing incentives for saving, investment, and growth will work. As these policies are continued a time will eventually come when market participants will realize that inflation will not average 6 percent over the next decade. When that happens market interest rates will fall, perhaps dramatically.

Concluding Comment

I have sought to emphasize that the vigorous economic expansion now in progress should not be greeted with a "good news is bad news" reaction. Although intuition should not be ignored, a "feeling" that there is trouble ahead is not a good reason to change monetary and fiscal policy. There should be no attempt to fine-tune policy in response to wiggles in monthly and quarterly data. Concentration on policy fundamentals is what is needed: a pro-growth fiscal policy with a declining budget deficit and a disciplined monetary policy characterized by gradually declining money growth. If we in government do our job the private economy will take care of itself very nicely indeed.

Table 1

Sector Contributions to GNP Growth: "Typical" and Current Recovery

	First 6 Quarters	
	Typical[1]	Current[2]
Real GNP (percent annual rate)	5.9	7.2
Contributions, in percentage points:		
(1) Personal Consumption Expend.	3.3	3.8
(1a) Durables	1.0	1.4
(2) Residential Structures	.7	.9
(3) Nonresidential Fixed Investment	.7	1.8
(3a) Nonresidential Structures	.1	.3
(3b) Producers' Durable Equip.	.5	1.6
(4) Change in Business Inventories	1.2	2.0
(5) Net Exports	-.2	-1.5
(5a) Exports	.3	.5
(5b) Imports(3)	.5	2.0
(6) Government	.3	.1
(6a) Federal	-.1	-0.0
(6b) Federal Excl. CCC Purchases	-.2	.4
(6c) State and Local	.4	.1
Final Sales (percent annual rate)	4.7	5.1
Final Sales adjusted for CCC Purchases(4) (percent annual rate)	4.6	5.5

(1) Average of recoveries from 1954II, 1958II, 1961I, 1970IV and 1975I recession troughs.

(2) Calculated from 1982IV recession trough.

(3) Negative contribution to GNP.

(4) CCC purchases removed because they are inversely related to the change in business inventories with dollar for dollar offset for PIK programs.

Table 2

Capacity Utilization and 1984 Investment Plans

	Capacity Utilization 1/		1984 2/ Planned Investment
	June 1984	1978–80 Peak	Percent Change
Manufacturing	81.8	87.5	15.5
Durable manufacturing	81.3	89.4	18.6
Steel	71.0 (May)	97.5	9.6
Nonferrous	83.4 (May)	98.2	10.5
Fabricated Metals	76.7	90.0	13.9
Electrical Machinery	91.6	90.6	23.5
Non Elect. Machinery	76.7	83.1	12.8
Motor Vehicles	85.7	94.5	38.9
Aircraft	74.7	93.9	10.8
Stone, Clay and Glass	79.1 (May)	90.4	9.5
Nondurable Manufacturing	82.4	87.2	12.7
Food	79.8 (April)	85.2	7.5
Textiles	85.7 (May)	91.3	24.4
Paper	95.4 (May)	95.1	16.0
Chemicals	72.6 (May)	83.6	13.5
Petroleum	81.1	93.0	10.4
Rubber	94.8 (May)	91.5	17.5
Mining	75.9	90.4	18.1
Utilities	85.8	86.8	7.1
Electric	84.4	87.0	1.7

1/ FRB Capacity Utilization - Release date July 16, 1984

2/ Commerce (BEA) Capital Spending Survey - Release date June 11, 1984. Nominal investment plans reported by business in April and May 1984.

Table 3

Short and Long-Term Inflation Expectations (Expressed as Annual Rate of Change)

Survey Quarter	Average change over: One Quarter[1]	4 Quarters[1]	10 Years[2]
1968:IV	3.3	3.3	
1969:IV	3.1	3.1	
1970:IV	5.1	3.6	
1971:IV	3.4	3.3	
1972:IV	4.1	3.6	
1973:IV	6.0	5.2	
1974:IV	8.9	7.7	
1975:IV	5.8	6.0	
1976:IV	5.7	5.7	
1977:IV	5.4	5.7	
1978:III	6.3	6.6	6.2
1978:IV	7.4	7.0	
1979:II	8.3	7.9	6.8
1979:IV	8.2	8.2	
1980:II	9.7	8.8	8.6
1980:IV	11.6	9.6	8.8
1981:I	9.7	9.1	8.3
1981:II	8.6	8.8	7.9
1981:III	8.7	7.8	7.6
1981:IV	7.6	7.4	7.7
1982:I	6.2	7.1	7.2
1982:II	6.2	6.3	6.8
1982:III	6.1	5.9	6.7
1982:IV	5.5	5.6	6.6
1983:I	4.6	5.0	6.3
1983:II	4.3	4.8	6.6
1983:III	4.7	4.9	6.6
1983:IV	5.6	5.4	6.6
1984:I	4.6	4.8	6.8
1984:II	5.5	5.4	6.7

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[1] Quarterly National Bureau of Economic Research/American Statistical Association Survey of Economic Forecasters. Inflation measure is the implicit GNP deflator.

[2] Decision Makers Poll by A. G. Becker Paribus, Inc. Final survey month shown for indicated quarter if more than one survey was conducted within the quarter. Inflation measure is the CPI.

The **Chairman**. Thank you, Dr. Poole. Last week when Chairman Volcker was here I discussed some of the mechanics of handling monetary policy or at least reporting it, as I have done many times. I spoke to him about two things.

First of all, the weekly release of M1 figures and how everyone agreed that they were inaccurate yet people based decisions on them and shouldn't we do away with the weekly reporting and at least go to monthly. Second, on the delay of 45 to 60 days in releasing of the Federal Open Market Committee's [FOMC] summaries of their actions, he indicated that there would be too much uncertainty if the summaries were released. I fail to understand that.

All the guessing that goes on during that period of time. It seems to me that there is a great more uncertainty with people trying to anticipate what the Fed is doing rather than being told what they are doing.

What's your feeling about the situation? The weekly reporting, and then the other side of the coin, that we, at least what I feel, are inordinate delays and what the FOMC is doing?

Mr. **Poole**. Let me preface my remarks by saying that my comments are, of course, personal comments. This is an issue for the Federal Reserve and Congress. So, my comments are more those of an academic from Brown University than they are a member of the administration.

WEEKLY MONEY SUPPLY DATA

First, a comment on weekly money supply data. I do not believe that the data should be eliminated as long as the data are collected and calculated by the Federal Reserve and as long as the Federal Reserve pays some attention to the numbers. Then it is inevitable that the market would be interested in what those numbers are.

If the data are calculated and used internally but not released, there would be two kinds of problems. One would be leaks and a second would be speculation on exactly what the numbers are. Even putting the leaks aside, there will be many who will try to calculate from available data what the weekly numbers are. It would be much better for the Federal Reserve, if it is calculating them internally, to release them as they do now so that the market is not making guesses about what the Fed's numbers are.

Second, in terms of reporting FOMC decisions, in my view the essential distinction here is between, on the one hand the FOMC decisions and the reporting of the decisions and, on the other hand the reporting of the FOMC debate and internal discussions. I think there is good reason to report decisions promptly. And I mean by that as quickly as practical after the decisions are reached.

I think there is good reason to delay reporting on internal debates. In fact, the old memorandum of discussion—the detailed FOMC minutes that were maintained for many, many years and were released with about a 5-year delay—provides a very accurate record of FOMC deliberations that has been extremely important to scholars in their understanding the process. But these discussions may involve a lot of, "what if this happens, what if that happens," and so forth. It's sort of trying out ideas. It's a natural thing for people to do.

If all of that is going to be on the public record immediately, then, of course, you hold those very important discussions in private rather than in the public meeting. So, I believe that the debates should be reported but with lag. I believe that the actual decisions that are reached should be announced quickly.

The **CHAIRMAN**. I would agree with that. I certainly didn't mean to indicate that I thought a detailed reporting of their discussions—I just thought a summary of their decision should be released much earlier than the 45–60 day lag.

The Federal Reserve publishing target growth range is for three aggregates and monitoring the range of growth in a fourth aggregate. How do we in Congress evaluate the Fed's performance? There's been a great deal of discussion. Some of their targets sometimes are within, sometimes they're out. In other words, it's a mixed bag.

There are four aggregates. How should we try and evaluate what the Fed is doing?

Mr. **POOLE**. Here, again, let me give you an answer that is an academic's answer from someone who has followed monetary policy for many years.

FEDERAL RESERVE SHOULD HAVE SINGLE TARGET

In my view it would be desirable for the Federal Reserve to have one monetary target, not multiple targets. There is nothing that would prevent the Federal Reserve, given one target—and, of course, I would prefer M1—there is nothing that would prevent the Federal Reserve from saying that because of other developments, including the other M's, credit, anything else they want to look at, that there is reason for departure from the announced target.

That is, all the arguments that the Federal Reserve now uses for having multiple targets could be used with a single target. But with a single target the accountability issue would be much more clear and the Fed's direction of policy would be much more clear.

So, I would favor a single target but with the understanding, of course, that other considerations might be brought in to explain why M1 growth is on the upper side or lower side of the target range, or even under special circumstances departs from the target range.

The **CHAIRMAN**. Mr. Savin, who will testify later this morning, said in his testimony neither the 1982 nor this year's deficit reduction package had any kind of the desired impact as anticipated on the bond market. Would you agree with him?

Mr. **POOLE**. The debates here have to do with, of course, first the size of the interest rate impact of the deficit and, second, the effects on the deficits of those legislative actions which you mentioned.

Let's talk about the most recent example, the Deficit Reduction Act. I think that the main thing that has happened this year—the main surprise or unanticipated event—is that the economy has been much stronger in the first half of this year than people had estimated or forecast at the beginning of the year.

Fiscal policy has come out more or less as had been anticipated at the end of last year. Earlier this year I think most betting was that there would be a Deficit Reduction Act of relatively modest magnitude compared to the size of the déficit, but a real contribution—a downpayment, a step forward. All that was already discounted or included in interest rates at the beginning of the year and so there was no reason to anticipate that the actual passage of the act would have a large effect on interest rates.

The big surprise was the very strong economy with very strong credit demands. I think that's most of the reason why interest rates are rising this year.

The CHAIRMAN. Senator Exon has introduced a concurrent resolution on monetary policy. The Senate may consider it today or later this week. It's very brief. I'll just read it to you.

> The President in cooperation with the Board of Governors of the Federal Reserve System, should exercise appropriate authority to ensure that an adequate flow of credit be available to American farmers at a reasonable rate. American farmers should be treated no less favorably than foreign borrowers with parallel levels of risk and through the present cooperation of the Board of Governors, the Federal Reserve System should take noninflationary actions necessary to reduce interest rates which are currently at levels abnormally above the real cost of money.

Well, this is not unusual. We get several resolutions a year on the floor of the Senate concerning the Fed and or the President or both, which I think are usually political statements.

First of all, I don't know how the President does either one of those because I think there is a glaring omission which the Congress usually leaves out of these resolutions and that's Congress. I don't know any other body under the Constitution given the authority to appropriate money other than Congress. No President of the United States ever spent a dime not appropriated by Congress. Not this President or any other.

So, when I hear about the President's deficit I think we're ignoring the Constitution which specifies where appropriation bills start. But I suppose we'll pass this overwhelmingly. There may be one or two or three of us who will vote against a political statement during an election year, but would you agree there is rather a glaring omission of the Congress of the United States, the only body to appropriate money, has been left out of this resolution.

It usually is and it apparently has nothing to do with inflationary pressure, or spending, or anything else.

Mr. POOLE. Senator Garn, I don't often disagree with you.

The CHAIRMAN. Thank you. Senator Heinz.

Senator HEINZ. Senator Garn, thank you.

Chairman Poole, I'm going to be rather brief in my questions and I hope you can oblige in your answers because I have a markup at 10 o'clock on the Senate Finance Committee.

In your testimony you cited with some encouraging words that there seemed to be increases in nonresidential fixed investment where businesses were investing, and if you want to put my line of inquiry down as looking for bad news along with good, you're right.

HEALTH OF NET FIXED INVESTMENT

Is it your view nothwithstanding the sunny statistics in your report that net fixed investment is healthy in the United States at this stage of the recovery? The net fixed investment?

Mr. **Poole**. It's clear that gross fixed investment is doing very well.

Senator **Heinz**. I understand that.

Mr. **Poole**. And that's what's in my tables. Net investment subtracts from gross investment an estimate of the depreciation allowances on the capital stock. Obviously, if we can maintain the strong gross investment then the capital stock will rise and the economy will continue to grow so that all of that will show in net investment in a relatively short space of time.

The problem with looking at net investment in the short run is that there is a cyclical adjustment that is required. That is, we have some idle capital at present because we're not back to full capacity utilization, just as we're not back to full employment in the labor market. So, we have idle capital that is still being depreciated but is not now producing.

So, when we put that idle capacity back to work and the idle labor back to work and we continue to have strong gross investment as a percent of a higher total output, then net investment will behave very well.

Senator **Heinz**. I didn't get the answer to my question. I heard a lot of discussion and a lot of hypothetical. If, if, if. But, now, would you please respond to my question?

Mr. **Poole**. I believe that the environment is very, very good right now. Obviously, we can make policy mistakes that will cut short this expansion.

Senator **Heinz**. I guess, let me restate the question specifically as I asked it.

Is net fixed investment healthy right now? And all you're telling me that the climate is nice out there and that's not an answer to my question.

Mr. **Poole**. If you look at the net investment number, let's say for last year, it is lower than the postwar average for net investment. But I believe that it is insufficient to look at that number alone in a situation such as last year. We don't have these numbers except on an annual basis. To look at that number for a period like last year when the economy was operating at a level well below that justified by the size of the capital stock can be misleading.

Senator **Heinz**. You're saying that operating rates should be influenced by the amount of capital available for investment?

Mr. **Poole**. No; I am saying that to judge whether we are making progress on this dimension of capital formation, the net investment number—which measures the accumulation of capital, as you correctly point out—needs to be adjusted for the stage of the business cycle.

Net investment is always low in the recession and early recovery period. That's no different now. And net investment is always high in boom times.

Senator **Heinz**. Are we having a boom time right now?

Mr. **Poole**. I think the economy is doing very, very well.

Senator **Heinz**. Most people would say we're having a boom time. Is it not a fact that the ratio of net investment by business to U.S. national product right now is low, relative to any other similar stage of any other recovery we've every had? As a matter of fact——

Mr. POOLE. In 1983.

Senator HEINZ. How about through the first quarter of 1984?

Mr. POOLE. We don't really have many detailed numbers by industry for the first quarter.

Senator HEINZ. From what you know about the first quarter or two?

Mr. POOLE. We know real gross investment as a share of real GNP is at a postwar high in the second quarter and that investment has been rising very rapidly.

Senator HEINZ. Let's hope it does. But let me just ask you. You attempted to answer the question the first time by stipulating that there were certain areas where operating rates were not as high as they might have been. And you imply that had operating rates been higher that net investment would have been higher and would have been very healthy.

Now, what about net investment in those durable manufacturing industries you talk about on table 2 which have experienced pretty healthy operating rates such as electrical machinery. How are we doing in that investment in the electrical machinery?

Mr. POOLE. Senator, I don't have net investment details in front of me. All I have are the gross numbers.

Senator HEINZ. Let me try a hypothetical question for you. If it were true that net investment were lacking, and that the reason it were lagging is that people were investing in relatively short-lag, quick fixes with relatively quick paybacks and being rather adverse to putting any money into any long-term investments in truly new plant that would get genuine modernization, you have, for all attempts and purposes, to either totally rehabilitate a plant or start all over again.

You cannot put in computer controls or all the other kinds of modernization techniques you need without really almost starting from scratch. If in fact we knew that that was a trend, would you worry about it?

Mr. POOLE. Of course. But I think that is not the trend.

Senator HEINZ. I understand. I'm not trying to put words into your mouth. Would that trend suggest to you that we might risk what some people would probably call deindustrialization. If that trend which, for the record, I know you do not believe exists were in fact to exist?

Mr. POOLE. I guess I'm not a fan of that phrase.

Senator HEINZ. Well, you understand it's common language meaning, nonetheless. It means that we would have less basic industry rather than more. Would you agree with that?

Mr. POOLE. If that's what it is defined to mean, of course.

Senator HEINZ. I would define that as deindustrialization, even though I understand that you are adverse to the use of the term. What do we need to do to make sure that that trend which I worry about and fear exists and which you hope doesn't exist, doesn't either to the extent that it is defeated and to the extent that it's here to continue. What do we need to do?

Mr. POOLE. I think the essential thing we need to do is to continue with a fiscal policy and a monetary policy as I emphasized in my statement, that maintains the incentive to invest which is tied up with inflation as well, as I emphasized. I would hate to see deficit reduction take the form of tax increases that destroy the incentive to invest.

I think that it is particularly for those long lead-time large projects where utilization might see the biggest impact. In table 1 where we look at the composition of the recovery, you can see in lines 3a and 3b we've divided the fixed investment into the structures and durable equipment components. The strength in structures investment has been coming along.

Senator HEINZ. This is a pretty odd table, let me tell you. Sector contribution to growth in real GNP. I don't quite know what that is. It's an interesting measure and we can figure out what it means in the real world sometime. I don't know what it means. Except that there's been some improvement in gross investment which we've already gone over. That's what it means, doesn't it? It says very little about net investment.

Mr. POOLE. It's all in gross terms, that's correct.

Senator HEINZ. We know what it means. My time has expired. But I just want to ask you one question.

TAX INCREASE?

The Democratic Presidential nominee, Mr. Mondale, has said that he's going to raise taxes as soon as he becomes President, if he becomes President.

President Reagan has been accused by him of having a tax surprise. Are you going to fight tooth and nail anybody else in the administration who might propose to the President a tax surprise? Can we count on the Council of Economic Advisers to hang tough against any tax increase at all next year, is that the position that you're going to take?

Mr. POOLE. I think that from my statement, it's pretty clear what my own views are. These are views that I do express within the administration.

Senator HEINZ. And that is no tax increases?

Mr. POOLE. It seems to me that it would be a mistake to say that under no circumstances never, never, never will we ever raise taxes. It seems to me everyone knows that it might be necessary to raise taxes.

The President has said very clearly that if the day comes when it is clear that we cannot meet the national priorities that are required to be met through Government, when we cannot meet those by raising revenues through the process of economic growth, and we cannot bring the budget into balance or near balance by controlling expenditures, then we will have to raise taxes.

Senator HEINZ. Well, as you look at the budget, the President is clearly not going to go lower than 5 percent real growth in defense. That's between interest on the national debt and defense. You're talking about a very significant proportion of the budget, maybe 45 percent of it.

The appropriated programs have been pretty much cut by the Appropriations Committee, and when I say cut, I don't mean their growth has been restrained, I mean they have been cut. And most people say they can't go any lower on that.

So you're up to about 55 percent of the budget. Which leaves 45 percent of entitlements and all those other kinds of programs. We've got some pretty sensitive kinds of programs in there. How much would we have to reduce the rate of growth on those entitlement programs for a tax increase not to be necessary?

Mr. POOLE. That, of course, is going to depend also on how far the economic expansion goes.

Senator HEINZ. Let's be optimistic and say that the forecast of the Council of Economic Advisers, which is what—3 or 4 percent real growth over the next several years?

Mr. POOLE. The administration forecast is basically for a 4-percent trend.

Senator HEINZ. Fine. Let's say that 4 percent real growth forever is a reality. How much are we going to have to slow the growth of those programs? By what percentage?

Mr. POOLE. I suppose over the span of the next 5 years, if you can take—I don't have all the arithmetic in my head—but if you can take—obviously if you can reduce total expenditures by something in the neighborhood of 5 percent, along with economic growth, you would be going pretty definitely in the right direction.

Senator HEINZ. If you could reduce the rate of growth.

Mr. POOLE. By 1990, if you could bring those programs in—all the programs, now, taken together—in the neighborhood of 5 percent less than they are now estimated.

Senator HEINZ. Then they would have been?

Mr. POOLE. That's right.

Senator HEINZ. When you say those programs, you mean the entire general budget?

Mr. POOLE. Yes.

Senator HEINZ. We all know that most of the budget—when I say most, I mean more than 50 percent is pretty much untouchable for the reasons described, so that means you've got to bring things about 10 percent less than that part of the budget that previously was thought to be untouchable. The entitlement programs, is that right?

Mr. POOLE. If I may make a comment on this argument about part of the budget being untouchable, let me tell you a little story if I may.

I had a visit some time ago from an Ambassador from an European country whose government expenditures are up in the neighborhood of 60 percent of the GNP. After we talked about whatever it was he came to see me about, I said:

> Mr. Ambassador, excuse me but let me tell you that from time to time I use your country as an example of the problems we're going to get into if we do not find a way of bringing our Government expenditures under control.

He said,

> Oh, yes, we're getting things well under control now. If only we could get our budget down to about 55 percent of GNP by cutting to the bone, we'd be all right.

And I said:

> Well, what you call cutting to the bone at 55 percent of GNP would be an extraordinary expansion of Government for us. What is called cutting to the bone depends entirely on what people have become used to and what the political process has accumulated over a period of many, many years.

Senator Heinz. Just for the record, what is the total portion of GNP taken by Government and quasi-Government in this country?

Mr. Poole. Federal, and State, and local together, in the neighborhood of 35 percent, roughly speaking, of which about 25 percent is Federal.

Senator Heinz. Thank you. Thank you, Mr. Chairman.

Mr. Garn. Senator Humphrey.

DEFLATION—POSSIBLE CONCERN

Senator Humphrey. Thank you, Mr. Chairman. I popped in because I was hoping I would hear something new in the area of monetary policy. Perhaps I missed some of it but in any case, Mr. Poole, are you at all concerned, or do you share the concern that some have that we are entering a period of deflation?

Mr. Poole. No. I think that that's quite unlikely.

Senator Humphrey. But isn't it so that prices of commodities have been retreating broadly. Is that not something new and significant?

Mr. Poole. I think it's significant but I don't think it's something new. For example, we had falling commodity prices in 1967–68 as the general rate of inflation climbed. Remember that the inflation that lasted over this whole period after 1965 was really getting built into the economy in the late 1960's.

What people fear about deflation is generalized deflation accompanied by widespread bankruptcies and unemployment. That's why the word "deflation" calls up such a nasty image in people's minds. I just don't see evidence of things moving in that direction.

Senator Humphrey. Apart from the personalities involved, what do you think of the means by which we in this country regulate the money supply. How would you evaluate it. Is it a good system, is it working well. What are your thoughts on that subject?

Mr. Poole. There is ample room for technical improvements to the Federal Reserve's mechanism of controlling money growth. It's a subject on which I have written over many years. It's a technical subject with a wide variety of nitty-gritty features to it.

One problem that the Federal Reserve took care of recently was the transition from lagged reserve accounting to contemporaneous reserve accounting. There are other technical issues of about the same degree of excitement. And I think I should not get started on that.

Senator Humphrey. You say there's ample room for improvement. Do you mean beyond the unexciting little technical changes that have been made or are you saying there are some more sweeping improvements that you might make?

Mr. Poole. The main technical change that's been made so far is the move to contemporaneous reserve accounting. There's been some improvement in the structure of reserve requirements, movement toward equilization of reserve requirements for different banks. And that's also helpful.

Senator Humphrey. If you were starting up a country from scratch, what kind of a system would you set up to regulate the supply of money?

Mr. POOLE. I would enter a strong plea for—how shall we put it—having a somewhat constitutional approach concerning the monetary powers of the central bank—for finding a way to have more constraints on the activity of the central bank than we have now in the Federal Reserve Act.

I think it is worth noting that over our entire history until 1971 it was understood that we would maintain the gold standard. The view was that the Federal Reserve was committed—the Treasury, the Government—committed to maintaining the price of gold.

I'm not in favor of the gold standard, but that was an extremely important external constraint on the powers of Government to control money creation. I believe we need more constraints put back in, but they have to be well-designed for our modern era.

Senator HUMPHREY. I'm not trying to sharpshoot you here. I'm just trying to improve my knowledge on this score.

GREATER EXTERNAL CONSTRAINTS NEEDED

You mentioned external constraints. One of the things that bothers me about the way the Federal Reserve works today with respect to monetary policy is that essentially you've got a group of individual human beings making judgments, groping around in the fog, using highly imperfect indicators and forecastors. It just seems illogical to me.

I agree with you that there ought to be, to use your words, external constraints of some kind to replace what is essentially today a system wholly based on human judgment. Is that not correct? That in this important and central function we're relying wholly upon a group of human beings to exercise their judgment. Is that not a fair statement?

Mr. POOLE. But, let me emphasize that we have been moving—much less rapidly than I would like—but still there has been some progress in the right direction. Through the present system of monetary targets announced in advance and reviewed in hearings of this type, the Federal Reserve is now by law required to announce monetary targets and to provide an explanation to the Congress when it departs from those targets.

I believe that if that system became more thoroughly established in our institutional framework—in the expectations that we have about central bank behavior—if the Congress would ask harder questions of the Federal Reserve about departures from its own announced targets, that we would then move in the direction I'm talking about.

Senator HUMPHREY. Is money a commodity? And, if so, why should the regulation of money be placed in the hands of a few individuals and removed from the laws of supply and demand, if you will, or the equilibrium that is usually established by those laws? If money is a commodity why should it be removed from that process?

Mr. POOLE. Of course, the approach of this administration is to move as far as we can in the direction of market regulation of the credit activities of the financial sector as opposed to regulatory agencies providing the discipline of regulation. The basic reason why money, in terms of your question, differs from a commodity is that a commodity has a cost of production. Money has a cost of production, quite literally, that involves the cost of printing paper and it therefore requires some external control.

There is a tremendous incentive for private counterfeiting, for example.

Senator HUMPHREY. Will you let me interrupt you there. If money were tied to a commodity then it would lose that distinction which you just cited. Namely, that the only cost of production is ink and paper. If it were the counterpart, and exchangeable for some commodity that had a true cost of production, then would not that problem be obviated?

Mr. POOLE. That would take care of that problem but would create other problems, which was the historical experience with the gold standard. What we're interested in is stabilizing the general level of prices for all goods and services produced in the economy.

If there are significant changes in the relative prices of a particular commodity, caused, for example by discoveries of new gold deposits, then tying money to a particular commodity or even a group or basket of commodities runs the danger of causing a generalized price instability because there is nothing that says a particular commodity is perfectly correlated with all prices in general.

Senator HUMPHREY. I can understand that argument if it's based upon one commodity or a small number, but if it were based upon a large basket, would not that problem be largely eliminated?

Mr. POOLE. Historically, and let me again use the gold standard as an example, historically the relation of paper money to gold was maintained by central banks and treasuries committing themselves to buy and sell gold at the fixed price, actually maintaining a store or hoard of this metal.

Now, when we talk about tying money to a broad basket of commodities, we have a different problem because presumably we are not going to maintain storehouses full of each of these commodities so they can be purchased and sold in order to maintain these fixed relationships.

Senator HUMPHREY. There's got to be a better way. What we practice today in the way of monetary policy seems to me something akin to witchcraft, sorcery and I just think— I'm hardly an expert on the subject, as you can tell, but I've just got to believe that there has to be a better way to do it and one that relies less upon human judgment and more upon the realities of the marketplace.

I take it your answer to my earlier question, if you were starting a country from scratch, how would you regulate the supply money? I take it your answer is essentially the way we are with some fine tuning or would you do something basically different?

Mr. POOLE. Again, your asking very much a hypothetical question that ignores all traditions and inheritances. But I would try to put in some kind of a constitutional constraint on the creation of fiat money, paper money.

Senator HUMPHREY. What would that be?

Mr. POOLE. We could have a directive that would say that the central bank cannot create fiat money more than 2 or 3 percent a year or something like that.

Senator HUMPHREY. So you're a Milton Friedman?

Mr. POOLE. Actually I was a student of his.

Senator HUMPHREY. Thank you. I see. OK, my time's up.

The CHAIRMAN. Dr. Poole, we thank you for your testimony this morning and appreciate your willingness to be here.

Next I'd like to call to the witness table Patrick Savin, vice president and capital markets analyst, Drexel Burnham Lambert Inc. of New York and Dr. A. James Meigs, senior vice president and chief economist of the First Interstate Bank of California.

Good morning, gentlemen. Dr. Meigs, if you would like to begin.

STATEMENT OF A. JAMES MEIGS, SENIOR VICE PRESIDENT AND CHIEF ECONOMIST, FIRST INTERSTATE BANK OF CALIFORNIA, LOS ANGELES, CA

Mr. MEIGS. I'm A. James Meigs, senior vice president and chief economist of First Interstate Bank. I'm also a member of the economic policy committee of the Chamber of Commerce of the United States.

It's a privilege to appear before you while you're considering matters of such crucial importance. I'd like to submit a written statement for the record. It has charts at the end of the statement, which I hope you will follow along with when I get to them.

HIGH INTEREST RATES EXPECTED

It seems to me that one of the key issues is what the level of interest rates today tells us about expectations in financial markets. Interest rates are behaving as though investors and borrowers expect inflation in the future to be high and to stay there for a long time. This expectation of high inflation persists in the face of an actual fall in inflation rates.

Mr. Poole referred to this in his testimony.

If people in the markets believed the statements from the leaders of both political parties, the Senate, the House, the Treasury, and the Federal Reserve about their determination to control inflation—if those were taken at face value—interest rates would be a lot lower and more stable than they are. So the question is: Why this behavior? Why are interest rates behaving the way they are?

The second issue, it seems to me, is the risk to financial institutions and other businesses which is imposed by alternating waves of inflation and disinflation.

The cost of underestimating these risks in the 1970's can be clearly seen in the recent rise in failures and near failures of banks, savings institutions, securities firms, and many other nonfinancial corporations. The efforts of investors and borrowers to protect themselves against such risks make it increasingly difficult to finance long-term investment projects which we need for the growth and security of this Nation.

The third issue is the Federal budget. We hear a lot about the problems that fiscal policy causes for monetary policy. I would just remind you it's a two-way relationship, and that both fiscal and monetary policy would be more effective if instability in the other was to be reduced.

So, for your budget problems, monetary policy can make it's greatest contribution simply by reducing inflation and holding it down. That would directly reduce the cost of carrying the public debt. It would help all units of Government to estimate the costs of programs and to predict revenues.

Now I want to look at and review some of the historical evidence on these points. Most of this has been before you at other times, but I think it's interesting nevertheless. So the first chart is on inflation. We show here the percent change of the GNP deflator from year to year from 1948 through 1984. The narrow bars of the chart mark recession periods. And the projections for 1985 through 1989 I put on just to illustrate some possibilities. Those are not forecasts.

What stand out in the chart are three phases. The first phase from the end of World War II to the early 1960's, was a downward trend in inflation, with some wide swings. Then, starting in the 1960's, about 1964, we have this upward rollercoaster of inflation rates. So that's the second phase. Then the third phase is the fall of inflation that we've just seen, which is a sharp fall, the biggest one in many years. This phase has been very brief.

Now, many people are tempted to conclude that inflation has been vanquished for all time, judging by what has happened in the last couple of years. So, many economists and some officials are annoyed and surprised that financial markets do not believe that inflation is no longer a problem.

I would suggest to you that one of the reasons for this is that people in financial markets look for repetitive patterns in market behavior. We can certainly see a repetitive pattern in this chart, the upward rollercoaster. Most financial managers in business today have never seen anything except that upward rollercoaster. So it would be natural for them to think that this is going to continue.

They really have two fears. One is the direct fear of inflation, of what inflation does to corporations and consumers. Second, they fear the effects of Federal Reserve efforts to control inflation, which many people expect would mean a recession, and higher interest rates for a time because on that chart each time that inflation came down, it was accompanied by a recession.

So, I think the question we should address is this: Is inflation still on the upward rollercoaster, which would mean we have just had a brief respite, or is it on a downward trend, as in the 1950's? That would be a highly desirable development for the future of the world.

Then, if we look for ways to break that upward trending cycle of inflation and interest rates, it seems to me the use of monetary targets as required by the Humphrey-Hawkins Act, is the principal candidate, the one thing that would really work. So, I think that is where this committee has a responsibility and an opportunity, through your power of oversight, to ask the hard questions that Mr. Poole mentioned a minute ago.

Then we look at chart 2, showing what monetary policy has been doing for many years, starting from the war, and see the ups and downs. What we plot here are fourth-quarter-to-fourth-quarter changes, as though we had been using the monetary target system since 1946.

What immediately stands out in this chart is a pattern that is very similar to the inflation pattern. There were two phases, the downward trending phase and the upward trending phase, with lots of big swings.

Swings in the money growth rate did not become smaller after the Humphrey-Hawkins Act of 1978. We have had some of the largest swings on record just since 1978, which seems to be a contradiction of the purpose of the act. But I would say we have not yet had a conclusive test of monetary targeting, because for most of the time covered in this long history the Federal Reserve has been pursuing other targets, such as interest rates, and other money market conditions.

MONEY GROWTH'S EFFECT ON INFLATION

Another point to notice is that every time there was a major slowdown in money growth, there was a recession. This suggests that it is dangerous to cut the money supply growth vote too abruptly and too much in a short time.

Fourth, money growth strangely was lowest during recessions and highest during expansion periods, which seems to be just opposite to what you would expect of a countercyclical monetary policy. I believe this procyclical behavior of money supply really comes from the Federal Reserve's longstanding practice of trying to stabilize interest rates, rather than controlling the money supply. It means a procyclical policy.

Now chart 3 brings the two together, money growth and inflation. Because changes in the money supply affect prices with about a 2-year lag, we moved the money supply line 2 years to the right. Then if we look at, say, the year 1980, the inflation rate plotted for 1980 is plotted with growth of the money supply for 1978, 2 years earlier. So this shows you what are the effects of that.

Now, some points to notice. First, each surge of inflation since 1964 was preceded by a monetary acceleration 2 years earlier. This is very clear. I think it's rare in economics that we find such a close association, which is, of course, what would have been predicted from many years of study of money and prices.

Second, it's obvious that when money growth was running around 1 to 2 percent a year, we had inflation of about 1 to 2 percent a year. When money growth got up to about 8 percent or so a year, so did inflation. Third, when money growth hit a peak of 8 and 9 percent in the 1970's, inflation was even higher than the money growth rates, probably because there were associated with that period some effects of oil price changes. The one apparent discrepancy on the chart is in 1950–51, when we had a spike in inflation without any apparent monetary acceleration. That came when the Korean war broke out—consumers and businesses remembered World War II price controls, and rationing, and so there was a burst of stocking up on goods. This drove prices up briefly, but inflation fell back quickly.

I would remind you that the upswing of money growth that we have plotted for 1984 and 1985 has already happened, that is not a projection. That has, therefore, implications for future inflation. I do expect inflation to be higher in 1985 and 1986 than it is this year.

So this review of evidence suggests to me some strategies for monetary targeting of a sort that you might want to consider. The first point is obvious. It will be necessary to reduce money growth rates from current levels, in order to reduce inflation permanently. But we can't expect to see results within less than a 2-year period.

Second, if money growth is cut back sharply to get quick results, then that raises the risk of recession, and that has been a common mistake in the past. It suggests that policy should seek a gradual slowing. If, on the other hand, we use short run, money growth changes to stimulate higher output or reduce interest rates, these raise the risk of inflation later. This was the mistake made in 1976–78. Chairman Volcker made this same point in his statement. So the best strategy is a long-term program of reducing money growth by about 1 percentage point per year until we reach a level that gives us zero price change. That could be a zero change in the money supply. But we don't know that yet.

So what to do now?

The policy dilemma facing the Federal Reserve, this committee and the administration, I think was caused by an upsurge in money growth from 5.1 percent annual growth in 1981, to 8.7 in 1982, to 10 percent in 1983. That has happened, and that is why we would expect some effect on inflation to come in the future. Now unless there has been a big change in the relationship between money growth and inflation, this increase in money growth that has already happened could add roughly 5 percentage points to the inflation rate. If we are lucky, we'll get less than that as I implied with the moderate projections shown on the chart.

When I came before your committee last year, money growth had been very rapid, and I recommended immediately cutting back to a 8-percent annual rate. Since then, the Federal Reserve has not done much different than that. So I'm pleased to report, I think that has been a move in the right direction, as Mr. Poole said too, even though that slowing of money growth was too late to avert some rise in inflation in 1985 and 1986.

Last year, as you remember, some Federal Reserve economists and other economists said not to worry about inflation from this big money growth. They argued that the demand for money had increased for various reasons, and that the increase in supply which we saw that the Federal Reserve permitted, merely accommodated an increase in the demand. They showed there had been a fall in velocity, and that made it safe to increase the money supply and, in fact, desirable.

Well, I think that argument is wearing out now, because obviously the economy is booming along, which to me shows that that big injection of money had a powerful stimulative effect on spending and economic activity. Now a standard monetarist analysis would predict that a large injection of money in a short time would drive velocity down, and that is exactly what Secretary Sprinkel said in his testimony on the same day last year. He proved to be a good prophet. That is, income velocity was down only temporarily, and has been growing for the last four quarters at a 4.2-percent annual rate.

SLOWING OF MONEY GROWTH DESIRABLE

The slowing of money growth since last year is highly desirable, and so I believe this committee should support the Federal Reserve's announcement of reducing the money targets by another percentage point for next year, the year ending in the fourth quarter of 1985. But I also believe the committee should caution the Federal Reserve monetary authorities against overreacting to the current strength of the economic activity. There probably will be an inflation bulge sometime next year or the year after that, but that cannot be helped now. It was built into the economy by the Open Market Committee's decision to tolerate M1 growth, way outside of their target bands in 1982 and 1983. So now we have a problem of containing this inflation bulge without either letting it get bigger, as in the case of the expansionary projections in chart 1 or pushing the economy into a downturn by overreacting.

It would be far better to set a long-term course of gradual reductions in monetary expansion and adhere to this course, whatever the temptations to respond to transient developments in the economy.

Now the big issue here is credibility. Financial managers of all kinds are desperate for any clues as to Federal Reserve intentions. Security traders leap like startled gazelles anytime something happens that makes them think the Fed may respond with a change in policy.

Judging by their statements and by your questions, Senator, Federal Reserve officials evidently believe that they have to limit the amount of information they provide regarding their future policies, in order to protect their discretion and respond to emergencies. So announcing the Federal Reserve's monetary targets has done less to stabilize expectations in financial markets than some monetarists had hoped.

I think the problem is with using multiple targets, M1, M2, M3, and other aggregates, simultaneously. That is tantamount to having no targets. So the financial market is continually confused by that.

The width of the target bands also greatly limits the amount of information provided to the public. Worst of all, I think, from the standpoint of providing market information, the monetary authorities have not demonstrated the ability or the willingness to achieve the announced monetary targets for any period long enough to convince the public that they are really serious. That is the basis for the market's skepticism, I believe.

Gov. Henry Wallich made a very good statement about the value of transmitting information to the market through performance. He said in a recent paper, and I quote:

> Setting and adhering to a target informs the public that an effort is being made to control inflation. Reducing the target over time creates a desirable and persuasive expectation of secularly diminishing inflation.

I think your committee would perform a very great service if you insist that the Federal Reserve do that. Some people argue about whether it's possible or not. I would just recommend looking at the case of Japan. I cite a recent study by an economist in Hong Kong, John Greenwood, a very capable man. The points he makes are much like those that Mr. Poole made and I made about what the Bank of Japan does. They announce an expected year-to-year growth rate for one aggregate. They pick one, rather than announcing multiple targets. They make this announcement without fanfare at the end of each quarter for the following quarter. And they have never deviated from the preannounced figure for the expected monetary growth rate by more than 1 percentage point since 1974. They have delivered on promises.

So the Japanese financial community has become so accustomed to this, they hardly pay attention when a new announcement is made, because they expect the Bank of Japan to follow through. Now the results of this strategy of gradual reduction of money growth over time, preannounced and gradual, are very instructive. Lower monetary growth sustained over several years has reduced inflation from double-digit rates to less than 2 percent per year. More stable money growth has also stabilized economic growth. Japan did not have the two recessions that we had in 1980 and 1982.

A more tentative finding is that the Japanese monetary strategy also has had a major effect in stabilizing capital markets. Japanese stock prices, in particular, have become much more stable than they were before the beginning of the Japanese monetarist experiment in 1974.

So I would suggest if the Japanese can do it, why can't we?

[The complete statement follows:]

Chamber of Commerce of the United States of America
Washington

U.S. CHAMBER CALLS FOR STABLE AND MODERATE GROWTH IN MONEY SUPPLY

WASHINGTON, July 31 -- Interest rates in this country are now behaving as though investors and borrowers expect U.S. inflation to rise to double-digit annual rates and to stay there for a long time, the U.S. Chamber of Commerce told the Senate Banking, Housing and Urban Affairs Committee today.

Speaking for the Chamber, A. James Meigs, senior vice president and chief economist of the First Interstate Bank of California, said that if government's expressions of determination to control inflation were accepted at face value in financial markets, interest rates would be much lower and less volatile than they are today. Whether or not the market's implied inflation forecast eventually proves correct, its contribution to high and volatile interest rates and to extreme uncertainty in financial markets today must be viewed with great concern.

"The safest strategy for reducing inflation, while minimizing the risk of recession," Meigs said, "would be a long-term program of gradually reducing money supply targets until a monetary expansion rate is found that would yield a roughly stable price level." But, he warned, an attempt to speed up the process by reducing monetary growth sharply would raise the risk of recession.

Meigs also noted that predictability and stability are key components of any successful monetary policy, and argued that Federal Reserve behavior between 1980 and 1983 were inconsistent with this prescription. Had monetary policy followed the path laid out in the President's Program for Economic Recovery, we could have avoided much of the economic deterioration that characterized the first few years of this decade.

LET'S REBUILD, AMERICA
IN THE 80's

Statement of the Chamber of Commerce of the United States

ON: MONETARY POLICY

TO: SENATE BANKING, HOUSING AND URBAN AFFAIRS COMMITTEE

BY: A. JAMES MEIGS

DATE: JULY 31, 1984

STATEMENT
on
MONETARY POLICY
before the
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
A. James Meigs
July 31, 1984

I am A. James Meigs, Senior Vice President and Chief Economist of the First Interstate Bank of California. I also am a member of the Committee on Economic Policy of the Chamber of Commerce of the United States. It is a privilege for me to appear before this committee when you are considering matters of such crucial importance to the future stability and prosperity of the U.S. and world economies. As Chief Economist of a bank operating all over the world, I see effects of U.S. fiscal and monetary policies in world financial markets every day.

Interest rates in this country are now behaving as though investors and borrowers expect U.S. inflation to rise to double-digit annual rates and to stay there for a very long time. U.S. financial markets are forecasting more inflation in the face of a fall in actual inflation rates. If the many statements from the leaders of both major political parties, the Senate, the House, the Treasury, and the Federal Reserve System expressing their determination to control inflation were accepted at face value in financial markets, interest rates would be much lower and less volatile than they are today.

Whether or not the markets' implied inflation forecast eventually proves to be correct, its contribution to high and volatile interest rates and to extreme uncertainty in financial markets today must be viewed with great concern by the members of this Committee and by other policymakers in the Government. Alternating waves of inflation and disinflation impose severe risks on financial institutions, other businesses, and consumers. Costs of under-estimating these risks in the 1970s can be seen in the recent rise in failures and near-failures of banks, savings institutions, securities firms, and non-financial corporations. The efforts of investors and borrowers to protect themselves from such risks make it increasingly difficult to finance long-term investment projects needed for the future growth and security of this nation.

We hear a lot about the difficulties the Federal Budget causes for the monetary authorities. But the relationship between fiscal policy and monetary policy is two-way; each would be made more effective by a reduction in the instability of the other. Monetary policy could make its greatest contribution to the budget process by reducing inflation and keeping it down. That would contribute directly to expenditure reduction by reducing interest costs on the public debt. And, even more important, maintaining a stable price level would greatly improve the ability of all units of government to estimate future costs of programs and to predict revenues. Government, like businesses and households, needs a stable monetary framework and a stable price level in order to maximize productivity and efficiency in delivering services.

The Historical Evidence

The charts at the end of my statement should help to explain why people in financial markets have such a cynical, skeptical view of government promises to control inflation. Chart 1 shows annual average inflation rates since 1948. The narrow bars identify recessions. The projections for 1985 through 1989 in the shaded areas at the end of the chart illustrate two plausible future courses for inflation under alternative assumptions regarding monetary policy; these are not forecasts.

Three major phases stand out in the inflation record. In the first phase, from 1948 to 1961, inflation came down in stages from the peaks reached in World War II and the Korean War. This downward movement in inflation was accompanied by four business recessions.

In the second phase, inflation rose again on an upward sloping roller coaster track from 1964 through 1981. Each peak was higher than the one before it and the inflation troughs were also progressively higher.

In the third phase, from 1981 through 1983, inflation fell farther than in any other comparable period shown on the chart except 1948-1949. For the first time since 1961, an inflation trough was lower than the one that preceded it. Both the Carter Administration, which began the new anti-inflation program, and the Reagan Administration, which made reducing inflation one of its primary objectives, had hoped for a more gradual, less costly campaign. Nevertheless, bringing inflation down to such a low level within four years was a stunning achievement.

It would be tempting to conclude now that inflation has been vanquished for all time. Some economists are annoyed or surprised that people in financial markets are unwilling to believe that, as shown by the high levels of interest rates. Financial managers, however, are accustomed to looking for repetitive patterns in market behavior. Many of those in business today have never seen anything but the upward roller coaster pattern in inflation rates and interest rates. It would be natural for them to suspect that something in our political-economic system made the U.S. economy increasingly unstable and inflation-prone after the early 1960s. What many of them fear perhaps more than the next wave of inflation itself is the eventual effort of the Federal Reserve to suppress it. They have reason to fear, from recent experience, that a new anti-inflation campaign could mean higher interest rates for a time and another recession.

For reasons to be explained in a moment, I believe inflation will be higher in 1985 and 1986 than it is now. That is a dismaying prospect. The question we must ask is whether inflation is still on the upward roller coaster of the 1960s and 1970s or whether it is now on a downward trend toward price stability, as in the 1950s. The 1985-1989 projections on Chart 1 illustrate both possibilities.

If we look for institutional developments that might break the upward-trending cyclical pattern in inflation and interest rates, the use of monetary targets by the Federal Reserve System, as required by the Humphrey-Hawkins Act of 1978, is the most likely candidate. That brings me to the second chart. Chart 2 plots fourth-quarter-to-fourth-quarter changes in M1 as though monetary policy had been guided by a series of annual M1 targets since 1946.

The first point to notice is that the pattern of annual changes in M1 growth rates is very similar to the pattern of inflation changes shown on Chart 1. First, M1 growth trended generally downward until the early 1960s, although there were wide oscillations from year to year. Then M1 growth moved upward in big steps to a new peace-time peak in 1983. The year-to-year swings in money-growth rates did not become noticeably smaller after passage of the Humphrey-Hawkins Act in 1978 and the change in Federal Reserve procedures in 1979 than they were before. However, there has not yet been a conclusive test of monetary targeting in the United States. For most of the years covered by the chart, and at times since 1978, the Federal Reserve has placed more emphasis on other operating targets, such as free or net borrowed reserves, federal funds rates, and other money-market conditions, than on the monetary aggregates.

Another striking feature of the chart is that every substantial slowing in money growth was followed by a recession. This suggests that lowering M1 growth targets by more than one or two percentage points from one year to the next would raise the risk of a recession.

It is also curious that M1 growth rates have been lowest during recessions and highest during the expansion periods between recessions, although the Federal Reserve has been viewed as pursuing contra-cyclical policies since the Treasury-Federal Reserve Accord of 1951. Textbook discussions of well-timed contra-cyclical monetary policies would have led us to expect just the opposite pattern: higher money growth during recessions and lower money growth during expansion periods, when inflation was more likely to threaten. I believe the pro-cyclical behavior of M1 resulted from the Federal Reserve's use of interest rates or net borrowed reserves as operating targets over most of the period covered.

The final chart, Chart 3, illustrates the historical relationship between money-growth rates and inflation. Because monetary expansion influences prices with about a two-year lag, we shifted the money growth line two years to the right when drawing this chart. Consequently, the inflation rate for 1980, for example, coincides with the money growth rate for 1978, two years earlier.

It can easily be seen that each upsurge of inflation after 1964 was preceded by a monetary acceleration two years earlier. Each fall in the inflation rate after 1964 was preceded by a fall in the rate of monetary expansion two years earlier. The one apparent major discrepancy in the pattern was in 1950 and 1951, when inflation leaped upward and then fell back. The contraction of the money supply two years earlier should have been strongly deflationary. In this case, consumers and business managers, with memories of World War II price controls and rationing still fresh, embarked on a buying spree when the Korean War broke out.

Some Implications for Monetary Targeting Strategy

This brief review of the historical record of M1 growth, inflation, and recessions has, I believe, some clear implications for monetary targeting that you may want to consider in your oversight responsibility for monetary policy:

1. To reduce inflation, it clearly will be necessary to reduce money-growth rates from current levels. However, visible results should not be expected until a year or two later, because of the two-year lag between changes in money-growth rates and changes in inflation rates.
2. If the authorities reduce money growth sharply, in an attempt to get prompt results, the risk of recession rises.
3. If the monetary authorities use short-run increases in money-growth rates in an attempt to hold interest rates down or to stimulate more rapid growth in real output, they risk raising inflation rates (and interest rates) later. That was the mistake made in 1976 and 1977, when a lull in the 1970s inflation appeared to offer an opportunity for using expansive monetary policies to increase output and to reduce unemployment.
4. The safest strategy for reducing inflation, while minimizing the risk of recession, therefore, would be a long-term program of reducing M1 targets by about one percentage point per year until a monetary expansion rate is found that would yield a roughly stable price level.

One criticism of a long-term gradualist strategy in monetary targeting is that the progress in reducing inflation might be too slow to be credible to the public. That would increase adjustment costs by delaying adjustments in prices and wages. Credibility might be established more rapidly by a shock treatment, such as reducing money growth to a non-inflationary rate in one step. The recession induced by a monetary shock treatment could be so serious, however, that it could undermine public support for controlling inflation; the cure might be worse than the disease. I have more to say on the credibility issue later.

The Current Situation

Today's policy dilemma for this Committee and the Federal Reserve results from the upsurge in M1 growth from a 5.1% annual rate in 1981 to an 8.7% annual rate in 1982 and a 10% annual rate in 1983. Unless there has been a major change in the relationship of M1 to national income and prices, this acceleration in monetary expansion could add roughly 5 percentage points to the 1983 inflation rate of 4.2% by 1985, bringing it to about a 9% annual rate. The actual increase in inflation by 1985 may be less than that, if we are lucky, as implied in the "Moderate Case" projections for 1984 and 1985 shown on Chart 3.

When I appeared before this Committee on July 21 of last year, I recommended that M1 growth should be reduced immediately to an 8% annual growth rate and held there through the second half of the year. The unrevised data available at that time indicated that M1 had been growing at more than a 12% annual rate since the middle of 1982. Although it may already have been too late to avert some reacceleration of inflation for late 1984 and 1985, it seemed high time to start moderating that reacceleration before it could get out of hand.

Some Federal Reserve and other economists argued last year that there was little need to worry about an inflation threat arising from the extraordinary growth of M1. The demand for M1 had increased for various reasons, they argued, and so the increase in the supply permitted by the Federal Reserve from mid-1982 through mid-1983 merely accommodated the increase in demand. A fall in (M1) income velocity over that period was cited as evidence that the demand for M1 had increased, making it safe, indeed desirable, to increase the supply. That argument is wearing thin now, as economic activity and spending boom along at far higher rates than the money-demand-shift argument implied.

A standard monetarist analysis would predict instead that a large injection of new M1 in a short time would cause income velocity to fall for a while, offsetting part of the impact of the faster money growth on current spending and income. Monetarists would attribute the observed fall in velocity more to the sudden increase in supply than to an increase in demand. Furthermore, velocity growth would rebound later on toward or above its trend rate of 3% or so per year. Dr. Beryl Sprinkel presented that argument in his appearance before this Committee a year ago. He proved to be a good prophet; income velocity has grown at a 4.2% average annual rate for the last four calendar quarters.

The slowing of M1 growth since this time last year to about a 6.7% annual rate through June was a highly desirable development. It certainly has not yet put a damper on economic expansion, as the increase in velocity I have just cited offset most or all of its downward influence on total GNP in current dollars. I believe this Committee should support the Federal Reserve in reducing M1 growth by another percentage point in the target for the year ending in fourth quarter 1985. This may not be a popular move in financial markets at first, because some analysts will expect it to mean high interest rates and some may forecast a recession. After they think it through, however, many people in financial markets should be reassured by the evidence that the Federal Reserve is serious in its determination to resist inflation.

I also believe this Committee should caution the monetary authorities against overreacting to the current strength in economic activity. There indeed probably will be a bulge in the inflation rate late this year and next year. But that can't be helped now; it was built into the economy by the Open Market Committee's decision to tolerate M1 growth above the 1982 and 1983 target bands. The problem now is to contain the new inflation bulge without either letting it get bigger, as in the "Expansive Case" projections in Chart 1, or pushing the economy into a downturn by overreacting. It would be far better to set a long-term course of gradual reductions in monetary expansion and adhere to it, whatever the temptations to respond to transient developments in the economy.

Credibility: The Instructive Case of Japan

Realizing that anything the Federal Reserve does will have important near-term and long-term effects on the world economy and financial markets, investors, borrowers, and financial managers of all kinds are desperate these days for any clues to Federal Reserve intentions. Securities traders leap like startled gazelles at any development they suspect may trigger a Federal Reserve response. The crowds of people trying to get into this hearing room on the days that Chairman Volcker announces new Federal Reserve targets are evidence of the thirst for information on future monetary policies.

Judging by their statements in hearings such as these, Federal Reserve officials evidently believe that they must limit the amount of information they provide regarding their future policies in order to protect their range of discretion for responding to unforeseen conditions and emergencies. But that leaves the public uncertain about the future purchasing power of money and makes it difficult for managers, investors, and consumers to plan.

Announcing the Federal Reserve's monetary targets has done less to stabilize expectations in financial markets than monetarists had hoped. This is because announcing multiple targets for M1, M2, M3, and other aggregates simultaneously is tantamount to announcing no targets. Outsiders have no way of knowing which target the Open Market Committee is emphasizing at any given time. The width of the target bands also greatly limits the amount of information provided to the public.

Worst of all, from the standpoint of providing market information, the monetary authorities have not demonstrated the ability or the willingness to achieve announced monetary targets for any period long enough to convince the public that they are really serious. In the absence of such a demonstration, much market energy is used trying to find out what else the authorities are trying to do.

Governor Henry Wallich expressed the value of transmitting information on monetary policy through performance when he said in a recent paper, "Setting (and adhering to) a target informs the public that an effort is being made to control inflation. Reducing the target over time creates a desirable and persuasive expectation of secularly diminishing inflation."[1]

The Bank of Japan has done just that. In a recent study in the Asian Monetary Monitor, Hong Kong, John G. Greenwood says that the Bank of Japan announces only the expected year-to-year growth rate for one aggregate, M2+CDs, rather than announcing multiple targets.[2] The Bank also sidesteps ideological controversy by calling the announced growth rate an expected growth rate, rather than a "target." An announcement is made without fanfare at the end of each quarter for the following quarter.

"The net effect," Greenwood says, "is that the Bank of Japan has compiled a remarkable record of never having deviated from its pre-announced figure for the expected monetary growth rate by more than one percentage point. The Japanese financial community has become so used to the predictability of the Bank of Japan's announcement and its success in achieving the predicted outcome that as an item of financial news the announced monetary growth rate is treated as no more than a minor formality."

The results of the strategy of reducing and stabilizing monetary growth in Japan are instructive. Lower monetary growth, sustained over several years, has reduced inflation from double-digit rates to less than 2% per year. More stable money growth has stabilized economic growth. Japan escaped recession during the two U.S. recessions in 1980 and 1981-82. A more tentative finding of Greenwood's study is that more stable monetary growth also has produced more stable capital markets. Japanese stock prices, in particular, have become much more stable than they were before the beginning of the Japanese monetarist experiment in 1974.

If the Japanese can do it, why can't we?

* * *Note: I want to express my appreciation to Noreen Doyas, Lillian McCalman, and Rodney Swanson for their help in preparing this statement.

Footnotes:

1. Henry C. Wallich, "Recent Techniques of Monetary Policy," Economic Review, Federal Reserve Bank of Kansas City, May 1984, pp. 21-30.

2. John G. Greenwood, "The Japanese Experiment in Monetarism", 1974 to 1984, Asian Monetary Monitor, March-April, 1984, pp. 2-8.

CHART 1

GNP DEFLATOR

% CHANGE OVER YEAR AGO

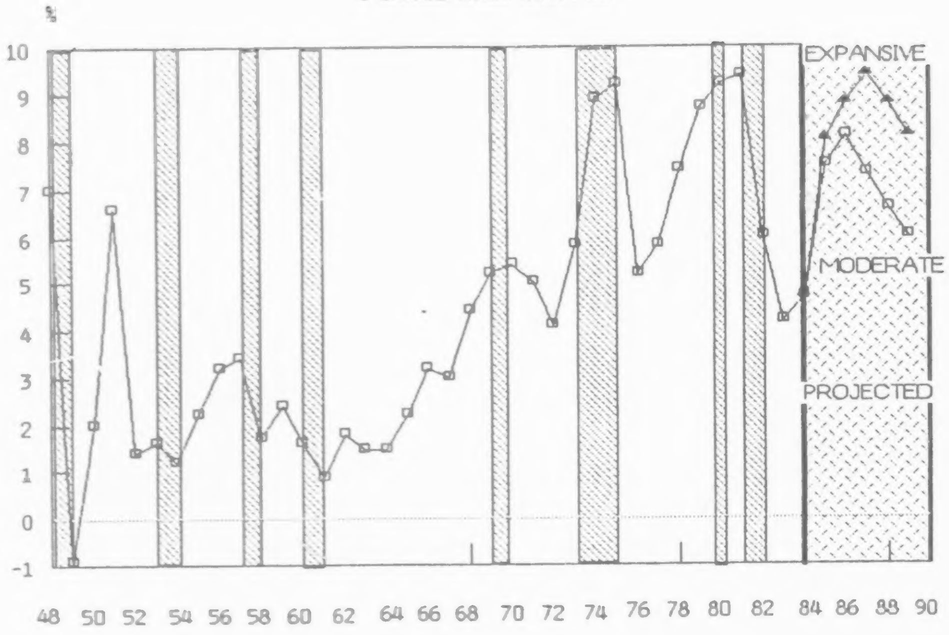

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CHART 2

MONEY SUPPLY GROWTH - M1

4TH QUARTER TO 4TH QUARTER % CHANGE

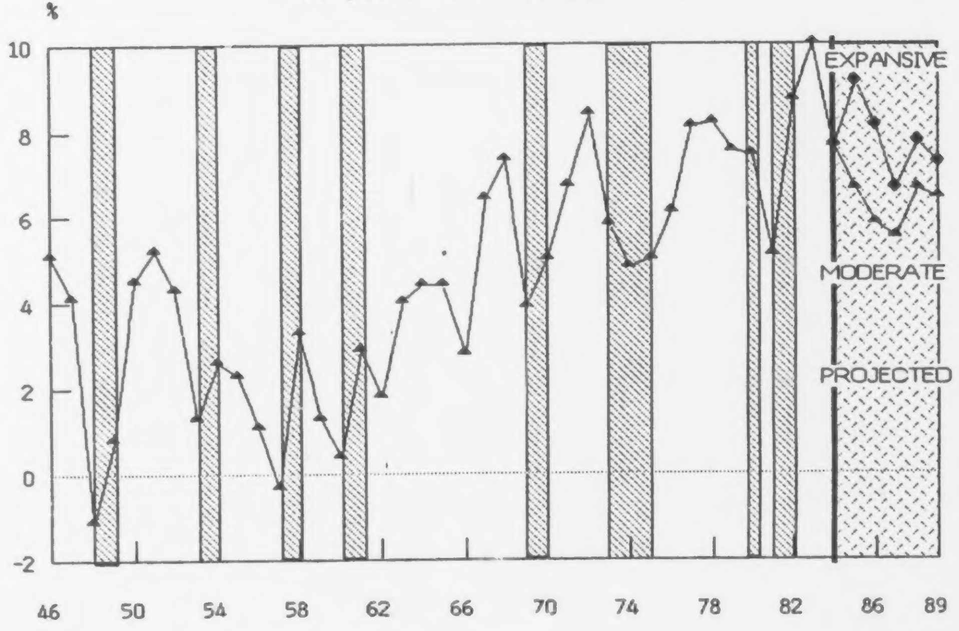

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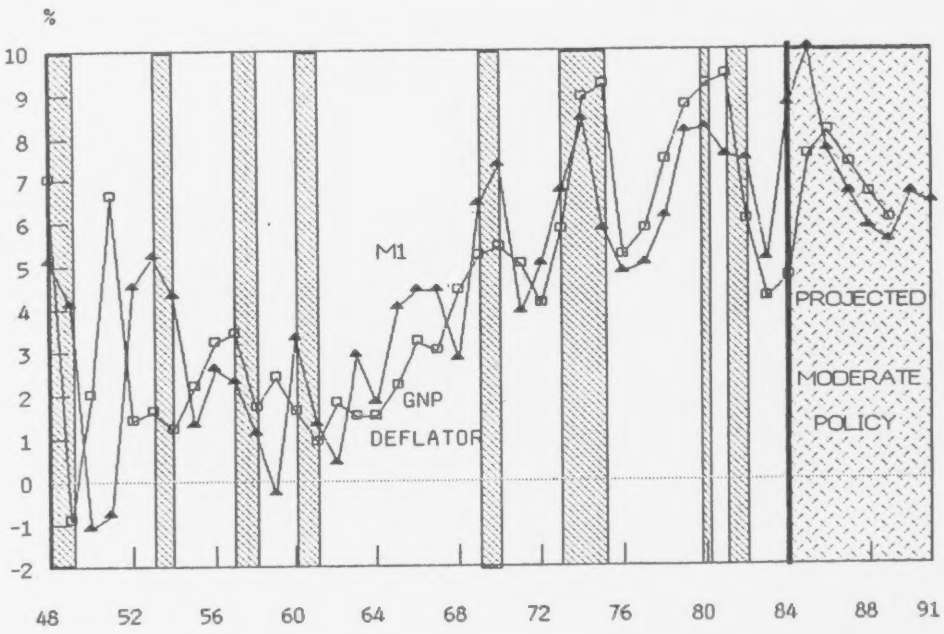
CHART 3

INFLATION VS M1 GROWTH TWO YEARS PRIOR

% CHANGE OVER YEAR AGO; 4TH Q TO 4TH Q FOR M1



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The CHAIRMAN. Thank you, Dr. Meigs. Mr. Savin.

STATEMENT OF PATRICK SAVIN, VICE PRESIDENT AND CAPITAL MARKETS ANALYST, DREXEL BURNHAM LAMBERT INC., NEW YORK, NY

Mr. SAVIN. Thank you very much, Mr. Chairman.

Mr. Chairman, prior to any discussion of details on Federal Reserve policy, I should point out that we are returning to financial stability, and the market is putting a premium on that journey.

There are two policemen on that journey. One policeman, of course, is the bond market in this country, which is no longer subject to manipulation by rhetoric or Federal Reserve Board action.

The other policeman, of course, is the currency market. It's a rather remarkable time, really, inasmuch as we're having asymmetric information from various markets. The commodity markets seem to feel that high inflation is not likely in the near or distant future. Second, the currency markets seem to take this view. The equity markets are somewhat positive, but of course, they're really hostages to the bond markets, since the major factor in the determination of equity values is the interest rate.

PREMIUM PUT ON LOW INFLATION

In order to return to this financial stability on which, as I say, the market has put a premium, we need to have some conviction first about persistent low inflation.

Second, that people can own financial assets as a haven of wealth, as a haven in which they can store their savings without abnormal price risk or credit risk. And obviously, there needs to be, third, improved quality of credit.

Fourth, we need to reduce risk premiums in the bond markets, in order to generate a secular drop in interest rates. Of course, what that would bring in its wake is higher equity values and a return to sustained economic activity, which it seems to me we all hanker after.

It seems to me that without this transition to financial stability, what we'll continue to have is the spasmodic economic growth of the last 15 years, characterized by the shift toward financial instability.

How can we get there? It's really quite simple. As you know, Mr. Chairman, we need to have a consistent application of public policy,

Let me just briefly, turn to the two areas of public policy that matter. First of all, Fed policy. Fed policy is always the key. The role of the central bank really is to maintain the value of the currency, and one of the paradoxes of life, certainly, with money, that commodity, is that you have to make it scarce in order to reduce inflation expectations and so as to raise its value. If you raise its value, you reduce interest rates and you set the stage for sustained economic activity.

As I say, that is the central issue in the process.

As we know by now, high money growth ultimately leads to high inflation. I think sometimes we do relax, but certainly as a rule of thumb, high money growth certainly leads to high inflation and eventually to high interest rates.

It obviously encourages a situation in which bad credits proliferate. Ultimately, and despite the rumors we hear, high interest rates do not prevent a secular decline of the currency. In an environment such as this you have problems in maintaining economic growth.

Now, what we are prescribing here in terms of policy is very painful. Make no mistake about that. If you get into a period of high inflation and high interest rates and encourage a speculative environment, people offer what appears to the borrower to be cheap credit and which the borrower thinks he can pay back in cheaper dollars.

If you start that game, as we saw in the period of 1980–82, as you move from this period of secular inflation through disinflation into a period of low inflation, it's extremely painful. Long persistent recession, high unemployment, high bankruptcy rates, various threats to the financial system which we have seen in the last 2 years and which we continue to see, become fairly typical.

But essentially what the market is insisting on and what we need to do, which can only be done by the Federal Reserve Board, is in fact to reduce the risk premium so that ultimately we have low interest rates. By this strategy we can restore credit quality because one of the dilemmas we face is that the bond markets have been really quite wrong in forecasting inflation for the last 2 or 3 years. The market continues to raise the risk premium.

The market has looked back at the record of 3 or 4 percent inflation of the last few years but it continuously discounts 10 percent inflation in an understandable frenzy or fear, one might say.

This high-risk premium encompasses a risk of inflation, a bankruptcy risk, second, and third, a price risk since our bond markets in particular have become far more volatile then they have ever been historically. Volatility has diminished somewhat over the last 2 years, but all this reflects in the financial instability one has talked about.

It is for this reason that the bond markets have now taken on a pattern of behavior which is both counterintuitive and counterfactual. We've seen in the last 4 years when there were rumors of the Fed easing. A few months ago Fed funds collapsed by off 150-basis points. The long end of the market promptly sold out. The interest rate ran up around 40 basis points in very short order.

FED HAS LOST CONTROL OF THE CURVE

When the Fed eases, in the traditional sense by trying to push down the funds by supplying reserves aggressively, people do not wait to see the inflation. They discount it almost instantaneously. The tragedy, therefore, of this dynamic financial instability is that the Fed has lost control of the curve.

When I started out in this business the Fed used to be able to manipulate the yield-curve. It looked very simple. We knew what the information content was of the Fed fund rates. We knew what information the Fed wanted to transmit to us.

Now you can't really tell. It has the information content but you're not sure what it is. If it goes up you don't know whether it's because the Fed has not been providing reserves, or if it comes down we don't know whether the Fed is providing reserves. So until the numbers come out with the 2-week lag, exacerbated these days by the contemporaneous reserve requirements, and changes in reserve requirements, one doesn't know where one is. So, the markets are nervous and anxious.

The paradox, you know, is that in a period of stability the market went along with the central bank. It doesn't have to keep the risk premium that high inasmuch as there isn't that much risk in the financial system.

So, what we need to do here in terms of Fed policy is not only to set targets but to hit them. But which targets? I certainly agree that there are too many targets. What we, in fact, are seeing here are secondary targets. The target that really counts is reserves. Second, the nonbarred reserves are important and third, M1, we certainly don't need three M's.

The central bank doesn't control credit. Credit is a promise to pay money and if a banker extends credit, with or without collateral, one could anticipate that there will be a shift of wealth on the part of the borrower or he will use the credit to accumulate some asset that can generate cash flow.

Clearly the Fed cannot control both quantity and price and what it should focus on is control of quantity and let the market set the price. The market's going to set the price anyway.

I also believe that the targets of 4 to 8 percent are much too high. Targets are much too wide. They reinforce uncertainty and this is unfortunate because I think the preponderant responsibility of reducing inflation expectation and reducing the risk premium falls on the Federal Reserve Board.

Let me just briefly touch on the fiscal policy because I think fiscal policy has become the scapegoat for everyone. I think that the frequent tax changes that we're seeing—we've had three major tax bills in 3 years—is without precedent and it reinforces uncertainty.

The other factor is that the deficit we've spent so much time and energy arguing about is really a residual and from a financial point of view, purely from a financial point of view, is a bogus issue. It's a bogus issue because if you think of it in financial terms what the tax cuts do is recycle liquidity from the public to the private sector and that is a strategy by which you reduce financial risk. And it is not accidental that we concern ourselves with financial risk in the throes of recession. Thus, all the tax cuts or nearly all the tax cuts in the postwar period have come in periods of recession.

If you accept my statement that we are reducing financial risk by cutting taxes and recycling liquidity from the public to the private sector, just think of the fact that there is no credit risk in Government debt. So, in an environment of increased financial stability to raise taxes, when in fact nobody knows what the optimum marginal tax rate is, to take away liquidity from the private sector in order to reduce the Federal deficit so that the Federal Government can borrow less, seems to me makes no financial sense.

It makes no financial sense because one of the ways in which we reduce financial riskiness is by issuing Government debt in preference to private debt. Since even in a period in which there is a recovery, the private sector is still accumulating financial assets, and it would make sense for the private sector to continue to reinforce its own balance sheet.

TAX SYSTEM FAVORS HEAVY DEBT

I would also, in closing, just point out that there's one number in this country which hasn't changed in many, many decades. It's the nonfinancial debt GNP relationship. It's hovered around 1.5 despite levels of inflation or business activity. What changes dramatically, however, under that simple number is who generates the debt. And in most of the postwar period, up until 2 years ago all the debt, believe it or not, despite the persistent public deficits, was generated by the private sector. Individuals tripled their ratio of debt; corporations doubled it. As I said, the Federal Government ratio declined.

There's been a reversal of this recently, largely as a function of the tax cuts and large deficits which in my view the Government is running in a financially sensible way. It is instructive that the two attempts to reduce the deficit have failed to shore up the bond market's confidence. I would ask you to recall that in the last 4 years we heard constantly that these deficits that have been much larger than people thought, would keep inflation high. That's been dead wrong. Keep interest rates at record levels. Also dead wrong.

I put it to you, that the burden here of reducing the risk premium or the burden of returning to financial stability falls on the Federal Reserve Board. The Federal Reserve Board should accept the responsibility of reducing financial instability. If the markets had the conviction that this were the case, I think the risk premium would decline, interest rates would come down, the dollar paradoxically would continue to surprise people by staying strong because the forces that are really driving the currency are not really the interest rates but relative inflation expectations and we could look forward to a period of sustained growth.

But to do this we have to set lower targets and we have to narrow the bands. Thank you.

[The complete statement follows:]

STATEMENT OF PATRICK SAVIN, VICE PRESIDENT, CAPITAL MARKETS ANALYST, DREXEL BURNHAM LAMBERT INCORPORATED

The Federal Reserve Board should continue to commit itself to a consistent and clearcut policy which reinforces a tendency to low inflation. Evidence of that commitment would cause the present fearsome risk premium in interest rates to shrink, releasing the bond market from its present torpor and causing interest rises to fall. Importantly, this development will keep the dollar strong and move equity prices higher. Lower bond yields and higher equity prices would effectively lower the cost of capital, enhancing long term economic prospects. Without this Fed-supported transition to financial stability, economic growth would remain spasmodic. Thus the present review can come at no more critical time.

The Fed has done an admirable but excruciatingly difficult job in conducting policy over the last three to four years. Inflation has dropped decisively. Keeping it down is another matter. What America has come through in that period is the classic and historical move from high inflation to disinflation, a deceleration of prices with all the hardships which tend to accompany this evolution. In my view monetary policy can now move in such a way as to reinforce a tendency to low inflation for a considerable period. This progess has been made against a background of very considerable uncertainty at crucial periods as to the technical means that the central bank would use to actually translate hopes into deeds. It is time for this uncertainty to end. The Fed has to announce lower targets for money growth and then deliver on these goals. Failure to do this would tend to increase the present disequilibrium in asset markets. If one looks at the various asset markets the information in in the price is clearcut individually but confused and inconsistent. The apparent message from both hard and soft commodities is that inflation should stay low and that some of the risk are on the side of deflation. In the currency market the message since the fall of 1980 has also been clearcut. The markets seem convinced that expected relative inflation, the main force behind the rally of the dollar, should continue to run in favor of the U.S.. Moreover, domestic investors are keeping the risk premium and interest rates high fearing a new round of inflation, and are offering foreigners very attractive compensation with little opportunity cost in holding U.S. assets. The equity markets are hostage to the discount rate or risk premium in the bond markets and have given an increasingly poor performance in the light of higher interest rates.

Thus, the message from the bond market, the most important asset market is forlorn and negative. It seems to believe that a new round of inflation is inevitable and since the market is a forward looking mechanism it seems unconcerned that it has been wrong in forecasting inflation for the last two years.

Historically, the real long term interest rate in this country has hovered between 3% and 4%. Thus with current yields of 13% in the long term treasury bond what the market is forecasting is a recurrence of nearly double digit inflation. In fact wrong as it has been in forecasting inflation for the past two years, having kept the risk premium, the difference between the historic real interest rate and nominal interest rate at 700 basis points it has now chosen to raise it to over 1,000. Clearly something has to give since the information from these respective asset markets is asymmetrical. The currency markets and the commodities markets are in obvious disagreement with the bond market. The respective markets have different expectational sets. It is understandable that the bond market retains enormous anxiety after a bear market which has persisted for well over thirty years with six of seven significant rallies. This is the dominant experience of nearly two generations of participants. Both owners and managers now need some commitment from the central bank in regard to the secular reversal of inflation. It is for this reason that the conduct of monetary policy in particular has become so critical as we try to reverse expectations. In fact what the bond market, the most critical of the markets is saying, is that it fears extrapolating the recent past into the future. What the Fed must achieve is a commitment to low inflation that would allow bond markets to reduce the current risk premium. And this commitment to low inflation in a historic framework is a very painful journey with a very skewed economic and social impact. Any sustained surge in money, at some stage generates increases in inflation. But what also happens in this period is a excessive use of credit and a deterioration of national, corporate and individual balance sheets. As we have learned in the last few years and continue to learn, a reduction of inflation and a repair of the national balance sheet require a return to sound credit.

It is easy for some to talk about accepting the harsh lessons of disinflation as long as the sacrifices fall elsewhere. Moreover, as the last two years have shown patchwork and inconsistent legislation of tax policy reinforces the tendency to uncertainty and does not support a lower risk premium in interest rates. The notion that Congress can reduce the deficit by raising taxes is a prescription for frustration and disappointment. The cat is chasing its tail. Tax increases raise the probability of economic slowdown, a condition in which would generate an ever larger deficit. Surely no one would then prescribe a further tax rise.

The Fed thus plays the central role in this drama around the theme of the risk premium. Obviously, its role in masterminding a return to financial stability, or its attempt to take away the profit in inflation is an extremely unpleasant one. Occasionally, everyone's commitment is shaken. Some in Congress even threaten to mastermind the market by controlling interest rates in effect, evidence of their awareness of the unpleasantness of uncertainty. Attempted in the summer of 1980, it was an unmitigated disaster, combining unexampled market volatility and a deep recession. But in fact, it is the market, the people and the institutions who buy financial assets, that determines what risk they will take and therefore what the level of interest rates ought to be. Everyone should understand that the notion of the central bank setting and masterminding interest rates is not feasible in the present financial climate. Obviously, if the market had no role to play it is a safe bet that rates would, on balance, be low and less volatile. It is a paradox of finance that central banks can manipulate interest rates - indeed the markets will allow themselves to be manipulated by the central bank - in a period of financial stability. Thus in the 1950's the central bank could mastermind through its manipulation of reserve growth the level of the Fed funds rates and that would provide very precise signal to the markets as to what the Feds goals were. In that environment of stability the market would follow the Fed. The Fed was the house and the market was a player in the Fed's house. However, as the system became very unstable in the 1970's, the entire role was reversed. Firstly, the Fed has had to change its strategic play by moving away from an interest rate strategy to a reserve strategy. What this means is that the central bank no longer controls even the Fed funds rate for a protracted period as it used to in the 1950's and 1960's. As the Fed provides reserves in this new era of aggressive liabilities management in banks, it is bank demand for reserves that determines the level of the Fed funds rates apart from very short interim periods. There is great confusion and contradiction and disagreement about this in the financial markets. For clearly there is information in the price of Fed funds, but that information is no longer as accessible. Obviously, this creates great uncertainty and frustration. But as importantly, it has reduced the power of the central bank. Paradoxically, the rise of financial instability reduces the power of the central bank especially at a time when so many seem to expect so much from the Fed. The market has set the tone. It has become the house and the Fed has become a player in its house, a dramatic reversal. In my view, as we return to financial stability, an environment in which there is a reduction of financial risk, what will evolve more is that the market will forget about past mistakes, and allow itself to be manipulated by the central bank.

In this context therefore, what the central bank does is far more critical than what happens in fiscal policy. It is hard for the Fed to convince the market that it is about to reduce financial risk thus increasing the odds of higher returns on financial assets compared real assets or other commodities. And in order to do this, it has to slow the growth of money and ultimately bring about a slowdown in the growth of credit. Too often the terms money and credit are used interchangeably. High growth rates of money encourage profligate use of credit. Credit is nothing more than a promise to pay money. The extension of credit means that the lender is betting that the borrower has either some liquid assets, which might serve as collateral, that can be converted into money to liquidate the debt or alternatively that the borrower will use his credit to accumulate some assets which can generate cash flow to service and repay that debt. As a consequence everytime credit is given, increasingly what take place is a bet on future asset values and income growth both ultimate products of Fed policy. For these reasons, it is extremely critical that the Fed continue to slow the growth of money in the environment of 1985 and 1986, helping to reduce the risk premium in interest rates? The central theme of the operation of the central bank has to be less the evolution of the business cycle than a return to financial stability.

The Fed has made its own role more difficult in two ways. First, it has changed the manner in which it conducts monetary policy by making three significant changes in the last five years. An important rule of thumb is that these frequent changes are hard for most market participants to understand or at best they take a long time to grasp. There is a tendency for them to cause uncertainty, a factor which raises interest rates. In the fall of 1979, the Fed announced that growth of reserves would become the centerpiece of policy as it tried to hit its money targets. It thus rejected the postwar focus on the Fed funds rate. This was a recognition that the Fed could not control both quantity and price at the same time and that it ultimately decided to shift its attention to quantity. Postwar policy has focused on the price or level the Fed funds rate and had led to a period of significant inflation by the 1970's. But in addition to that, under the Monetary Control Act passed by Congress, the financial system had been deregulated, not so much to insure more competitive markets, but in response to the financial chaos which deepened in the 1970's. But these changes allowed the Fed to claim that since there had been institutional changes in the definition of money, it had to have wider targets, to compensate for these new definitions. Wider target increased uncertainty. The second major change came in the summer of 1982. The Fed abandoned its targets for some months, underwriting a significant spurt in money. This caused cynicism to deepen and fears arose that there would be a significant new round of inflation in late 1983 or early 1984. By now we know that was a terribly incorrect forecast. The money spurt, as evidence showed, was not validated by reserve growth and was merely a function of the new definitions of money. In short, some of these balances were not held for transaction purposes. The Fed did try to make this clear but few seemed to understand for a variety of reasons. A member of the Federal Reserve Board pointed out in a speech made last spring in Chicago, that a third major change in the conduct of policy took place in the fall of 1983. There is reason to believe that behind the shift to contemporaneous reserve requirements the Fed is now using the discount window as a prime focus of strategy with nonborrowed reserves the bulk of reserves as the residual. This last change has some similarity to the pre-1979 monetary strategy and should be a source of concern. To the degree that is causes confusion, it would tend to keep the risk premium high. In fact the third policy change was announced several months after it had been put into effect. Moreover, the Fed itself initially opposed the return to contemporaneous reserve environments but eventually supported it. However, it then said that the change to contemporaneous reserve environments from lagged reserve requirements would make little difference either to inflation expectations or to the conduct of its policy. If this is true, then why bother with all these changes?

It is important for the Fed, in as simple fashion as possible, make the currency secure. As everyone knows tight money - slow growth of money - leads to low interest rates and easy money - fast growth of money - leads to high interest rates. The difference in outcome lies in both inflation and inflation expectations. Slow growth in money and ultimately credit leads to low inflation. Risk premiums and interest rates ultimately decline. And despite that, the currency tends to stay high particularly since it also signals a reinforcement to financial stability. In this context much of our concern in this country for the budget deficit is misplaced.

As recent experience in both Japan and Germany show, high budget deficits do not necessarily lead to high interest rates, high currency and large trade deficits as the former Chairman of the Council of Economic Advisors suggested. This committee heard three to four years ago that the high budget deficit - the deficits have been much larger than anyone thought would keep inflation and interest rates at record levels and would indeed prevent the economic recovery. The problem now is that these same people are saying that the high budget deficits will prevent a sustained recovery. But this is really a canard. Business cycles are either accelerating or decelerating. This one has started to decelerate, and will continue to do so without policy support for lower risk premiums. What we need to do is to restore financial stability. And in this context budget deficits have a very important utility in that they improve credit quality since government debt is free of credit risk compared to that of the private sector. The transition from a persistent budget deficit to low inflation and low interest rates is feasible as in the case of Japan. It is a country reinforced by financial stability which is financing a significant introduction of new technology in industry. What matters is that consistent conduct of monetary policy reinforces a tendency to lower its risk premiums and keep interest rates low despite the large budget deficit. No attempt is made to monetise the deficit. Moreover, there are countries such as Italy in which the high budget deficit have emerged side by side with high inflation, high interest rates, significant trade deficits, and weak currency. What is the difference? It seems clearcut that it is conduct of monetary policy and the risk premium that financial asset owners demand. In fact one of the things that has become apparent is that is is possible to have high marginal tax rates and wealth taxes with a large government share of GNP and still have low inflation and interest rates, and financial stability. It is clear that the crucial difference is the consistent conduct in monetary policy and as a consequence the credibility and confidence investors have in the central bank.

As we have seen in the last two years, rapid and radical changes in tax policy in order to pacify the capital markets, is largely pointless. Congress passed a massive tax cut in October 1981. A major bond rally took place in the summer of '82, bringing the long term government bond down to 10¼% from its peak of 15¼% in September 1981. In September 1982, Congress passed the Tax Equity and Fiscal Responsibility Act (TEFRA) in order to reduce outyear deficits. And just recently Congress passed the Deficit Reduction Act of 1984 in another obvious attempt to pacify the market, the first having failed. What is important however, is that clearly neither piece of legislation by itself has made any difference in the bond market. Interest rates are now some 300 basis points higher than they were when the first piece of legislation was passed, and since the passage of the Deficit Reduction Act of 1984, the bond market has made no significant advance as some people had suggested it would in face of legistlation. Monetary policy is the key to lower rates and frequent changes in the tax measures reinforce a tendency to uncertainty.

An analysis of the strength of the dollar is also relevant in the context of an analysis of the Fed policy. No economically viable society in the history has ever had a weak currency. As members of the committee can recall, in the 1970's when the dollar was in a persistent decline, the same industries which may have trouble in holding market share had difficulties then. Since the strength of the currency reflect low expected inflation and also reduces flexibility to raise domestic or foreign prices in order to maintain a high rate of return on invested capital it encourages the introduction of the most modern equipment and technology to boost productivity and reduce costs. At the same time these steps encourage workers to moderate wage gains. This dynamic cycle is unsustainable without conviction in financial markets that the central banks means to validate a low rate of inflation. Since high risk premiums and interest rates and the high cost of capital can in the long run discourage new investment in countries with weak currencies or high inflation, all the pressure for lower costs then comes from attempts to reduce wages. But that is a short run tactic, and not a long term strategy. And in this context therefore the return to low risk premium and interest rates becomes a central issue. What the foreigners see is an opportunity to invest in America to produce their goods here in order to hold their market share. What the significant devaluation of the dollar in the 1970's has done is to make it attractive for them to invest here. A ten year recovery in the deutschmark above 2.80 from 1.65 leaves it substantially below the four marks to the dollar of the 1960's.

The yen has held its own against the dollar in recent years after a period of strength in the 1970's. With its greater financial stability, the currency should strengthen against the dollar, encouraging Japanese portfolio and direct investment in America.

As to fiscal policy, there is no question that despite present economic stringencies, government should strive for efficiency. Government has to make sure that its programs are efficient and it also has to ensure a further deceleration in the growth rate of government expenditures. Congress has cut the growth rate of government expenditures since 1980 despite the recession. It is the first time that this has happened in over twenty five years. However, frequent attempts to manipulate and change the tax system in an effort to reduce the deficit, is counter productive. One of the ratios that has not changed in over 50 years is the debt GNP relationship. It has hovered around 1.5 with little variance. This ratio has held despite the variability of economic conditions and inflation. What changes dramatically within this ratio are the sectors that generate the debt. Two things stand out. The first is that in the postwar period it is the private sector, both consumer and business, which has increased its share of financial debt. Government share of debt has been declining until recently. The second point is that in recessions private sector debt tends to decline cyclically as government debt rises. The reason for this is quite simple. What tax cuts do is recycle liquidity from the public to the private sector and the concern about liquidity is highest in recession. Consequently most tax cuts take place in recession. In recession, as the private sector cuts back on consumption and investment, and increases its liquidity, or in short saves more and changes the composition of its savings, the public sector is obviously able to borrow more. But what is also important is that the private sector then buys risk-free public sector debt to bolster its balance sheet and reduce its exposure to financial risk. Some now argue that without shrinkage of the budget deficit, in contrast to past periods, the private sector will not be able to to finance its growth, the "crowd out" effect. But past deficits have been widely off the mark. Consequently, nobody knows what the deficit is going to be in the future since it hinges not only the tax level which Congress has been trying to raise to cut the deficit but also on the level of economic activity. Budget deficits are residuals. They result from something and they really do not cause very much of anything. Therefore, basing public policy on some expected deficit which is virtually unforecastable makes little sense. As to fiscal policy therefore, what Congress ought to do is to try to come as close as possible to efficient outlays, however difficult this is politically, and allow the central bank policy to play the dominant role in reducing the risk premium. In any event in a period of such financial instability and turbulence it can make little sense to raise private sector taxes to reduce the government deficit in order to let the government borrow less. Government debt has price risk but no credit risk. Private sector debt obviously has both price risk and credit risk. If many of the banks in this country had owned more government paper and less private sector paper fewer banks would have gone bankrupt and fewer banks would now barely survive. Thus, in purely financial terms tax cuts that take away private sector resources to reduce government debt requirements make little sense and increase risk in the financial system.

Very uncomfortable burdens fall on the central bank. But life is not fair as everyone knows. To run a central bank is to take on an awesome responsibility for the course of inflation, interest rates, the value of the currency and ultimately economic activity. We need in this society to leave little question that the aim is to return to financial stability. The only way to achieve this, having reduced inflation, is to reduce inflation expectations. And the only way to do this is for the central bank to reduce the growth of money and ultimately credit so that inflation expectations will shrink. That in turn will bring about low interest rates, maintain the value of the currency, raise equity values to higher levels thus reducing the cost of capital implied by both lower interest rates and higher equity values. In such an environment there would be an increased probability that we would return to periods of stronger and sustainable economic growth and away from the spasmodic growth that the USA has experienced in the last fifteen years. This is not a pleasant prescription, particularly since it would be nice to suggest that the pain of the last few years has insured solution to all our problem. And yet the pain itself is a justification to complete this phase of the job. What the markets are saying, particularly the bond market, is that there is a need to see more consistency in the conduct of Federal Reserve Board policy if the risk premium and interest rates are to come down.

The **Chairman**. Thank you, gentlemen. Your entire statements will be included in the record.

PROPER PROCEDURE FOR MONETARY POLICY

Currently the Federal Reserve is now seeking to implement monetary policy on a day-to-day basis by controlling net borrowed reserves. Do you believe this is an appropriate procedure for monetary policy?

Mr. **Meigs**. No, the procedure of using borrowed reserves came out of the 1920's. It's very unreliable. It gives the Federal Reserve very little control over the rate of growth of money supply. It tends to produce a procyclical change in the rate of growth of bank credit and the money supply, just as would be the case if they were targeting interest rates. If credit demands tend to rise, then banks borrow more from the Federal Reserve and the Federal Reserve accommodates. Then you have an increase in money growth at just exactly the wrong time. I think this is a step backward. They would be far better off, as I think Mr. Poole suggested, to focus on total reserves not net borrowed reserves.

The **Chairman**. Your statement, Mr. Savin, argues that inconsistent changes in tax policies in recent years have contributed to current risk premiums in interest rates. To what extent do you believe that inconsistent tax policies contribute to high interest rates?

Mr. **Meigs**. I believe, too, that a fiscal policy should be very stable long term and I agree changes in tax rates do generate much uncertainty among business people, consumers, and investors.

So, it would be desirable, given a stable monetary policy, to set fiscal policy by long run reasons. That is, decide how much of the national income should be devoted to public purposes, Federal purposes, stick to it and minimize changes in tax rates. They are not useful in stabilizing the economy. They raise uncertainty and they reduce incentives of people. Increases in taxes reduce incentives for people to work, save, and invest. It's as simple as that.

The **Chairman**. Mr. Savin, do you believe that financial markets today are convinced that the Federal Reserve is committed to an anti-inflationary policy?

Mr. **Savin**. Well, sir, it's always very presumptuous to speak for the markets, but if I may, I think there are severe doubts about that, and you see those doubts reflected in what people call the real rate of interest. I prefer myself not to use that formulation. I prefer to speak about the high-risk premium. The risk premium is the difference between that real interest rate and the nominal interest rate. And we haven't seen the risk premium that we now have in many decades. So no, I don't think the financial markets are convinced.

The **Chairman**. Do you believe that Congress is largely responsible for that? We tend to gloss over, as I talked about with Dr. Poole before, about Congress never including itself in these resolutions, to demand stability in everything from the President and the Fed, but never from us. We just go merrily along being irresponsible without anybody condemning us very much.

We also find that there is a constant demand for expansion of the money supply. I can't believe that after 10 years of sitting on this committee, invariably some member of the committee and others will jump on the bandwagon of pushing the so-called low interest rate. But all we've got to do is demand that the Fed pump more money out there. Despite all the charges, despite all the evidence, despite all the inconsistencies of economists in other matters, there's one area where they're pretty darn consistent in all the ones I've listened around there, that expansion of the money supply too rapidly causes inflation and high interest rates.

My colleagues don't want to do that, obviously, because it's much nicer to blame the Fed and blame a President, this one or any other, for the failures of our fiscal policy.

CONGRESS IS RESPONSIBLE FOR UNCERTAINTY IN THE MARKETPLACE

Would you agree with me that Congress is responsible for a good deal of the uncertainty in the marketplace?

Mr. SAVIN. You know, sir, in institutions, we exist to be scapegoats for each other. [Laughter.]

The CHAIRMAN. But who is Congress the scapegoat for? I see us scaping.

Mr. SAVIN. You're obviously a scapegoat for everybody.

The CHAIRMAN. And when we have testimony, most witnesses can come in and condemn everybody else, but because they're facing a panel of Senators or Representatives on the other side, they're very timid in being honest about us, being not just the scapegoat, but the real cause of most of these problems.

Mr. SAVIN. It's simple what you have to do, isn't it? It's very hard in practice to do it, when you have to insist on a consistent monetary policy too, you have to have a consistent tax policy, you have to learn to tell special interests, no. The third thing you have to do is, you have to try and hold down the growth rate of Government expenditures.

The CHAIRMAN. Tax policy and fiscal policy are set here; right. No place else.

Mr. SAVIN. Absolutely.

The CHAIRMAN. Two of the three variables you're talking about are set by us.

Mr. SAVIN. Yes, and you have to strive to do a better job.

The CHAIRMAN. You're very kind. [Laughter.]

A better job—better than what?

Mr. SAVIN. Than what has been done.

The CHAIRMAN. Anything would be an improvement, in this Senator's opinion.

Senator Hecht, do you have questions you wish to ask?

Senator HECHT. Senator Garn, I'd like to pass, so I can hear the next speaker.

The CHAIRMAN. Senator Humphrey.

Senator HUMPHREY. With respect to one of the three elements we're addressing, namely, monetary policy, the difficulty cited by our witnesses, if I understood them, is that the financial markets have little faith that we will not return to inflationary monetary policy, either deliberately or indeliberately; is that correct?

The point I'm trying to make in putting that question is, once again, that monetary policy and all of the things that gather around it that control interest rates and so on, are in the hands and at the discretion of a few human beings set instead of determined by some other constraint, mechanical system or whatever. I don't know exactly what that alternative should be, but I'm trying to find someone who will tell me what it should be, because I think what we have is very poor.

Mr. **Savin**. Whatever mechanical constraints you'd design, would be designed by human beings, I'll remind you.

Senator **Humphrey**. Yes, but you can still instill discipline, if the marketplace has a greater say in these matters, as opposed to exclusive reliance on the judgment of human beings, a few human beings, who are unaccountable, essentially, to anyone.

Mr. **Meigs**. I agree. You ought to have long-term monetary policy. And the degree of discretion that the Federal Reserve uses now is one of the great causes of market uncertainty. If people in the market knew that the Federal Reserve was aiming at a particular rate of growth in the money supply, the market then could adjust to all sorts of things. But if they think, well, today, they're aiming at the money supply, next week it will be something else, the week after that still something else, and every time something happens to the market, they're going to do something, the market is continuously in a fever of anxiety over what the Federal Reserve is going to do next. That is the great cause of the risk premium that he's talking about. And you, I think, in the Senate have the responsibility, if the Federal Reserve gives you a set of monetary targets, to see to it that they deliver.

FED NEEDS TO BE HELD ACCOUNTABLE

Mr. **Savin**. There have been about four major changes in Federal Reserve Board policy in the last 4 years. I don't know if you people have tried to ask them for rhyme or reason. There was one that one of the members of the Board announced quite by chance this spring in Chicago.

And you know, that's the whole thing.

Senator **Humphrey**. The difficulty is that we have no means of holding them accountable, have we?

Mr. **Meigs**. The Federal Reserve Act was written by the Congress. The Federal Reserve Act can be amended, if you see reason to change the system. In effect, I think that's one of the great fears that the Federal Reserve has, which is one of the reasons they like to be as little accountable as possible.

Senator **Humphrey**. My view is that we have to make some reforms. The system we have now is not working; it has no stability; it changes from year to year. We try and they try one method one year and another method another year. They bounce off one wall, and then in reaction, they bounce off another wall. It's incredible. It would be funny, if it weren't so tragic, if it didn't have such tragic consequences for every citizen of our country.

Mr. **Meigs**. And the world.

Senator **Humphrey**. If you were us, what would you do, specifically?

Mr. **Meigs**. One suggestion was made at the beginning. In 1981, the program that the new administration proposed included a provision that the Federal Reserve reduce the growth rate of the money stock on a preannounced track and gradually, over a period of 4 and 5 years. But that was not the policy that the Federal Reserve delivered, and as far as I know, the Federal Reserve never accepted that as a policy instruction. It preferred to go year-to-year, or month-to-month, or day-to-day in its policy.

Senator **Humphrey**. Mr. Savin, did you think that changes were needed in the Federal Reserve Act to address the other problems that you've cited here?

Mr. **Savin**. Clearly.

Senator **Humphrey**. What changes would you recommend?

Mr. **Savin**. I think that we have to first of all separate what the Fed is from what the Fed is not and what the Fed cannot do. The Fed's prime targets are reserves. The secondary targets are the money targets, and ultimately what happens in the business cycle. And what we should do now is focus on the primary targets, set them by legislation and simplify things.

Senator **Humphrey**. So you would change the act to strive toward consistency and clear goals?

Mr. **Savin**. Oh, yes.

Senator **Humphrey**. You're satisfied that the Federal Reserve System would pay out money?

Mr. **Savin**. Sure; absolutely. I don't see fiat money as a problem per se. You know, people forget that even under the gold standard, we had inflation, deflation, and cycles. Again, you have the human restraint. That's something you always have to deal with. You have the human problem that we talked about.

Senator **Humphrey**. That's precisely the problem. It's in the hands of human beings, a small number of human beings. It just seems as though there's got to be a better way, but failing fundamental changes, I certainly agree with what you said we need to make changes in the Federal Reserve Act to clarify goals and assure consistency.

Is there any legislation of which you are aware that would do that?

Mr. **Savin**. I am sure that the Senate and House have got several bills on Federal Reserve Board policies, one aspect of it or the other, but I don't know whether they are specifically the same with regard to simplifying the job.

Senator **Humphrey**. I wonder if the chairman knows of any such legislation or if he's been following our discussion here.

The **Chairman**. I have been following your discussion. The discussion has been going on for many years in various forms over what to do with the Fed to make them perform. I know of no legislation that can accomplish that. We've had lots of different suggestions. I don't know a year that we haven't had bills to make the term of the Chairman coterminus with that of the President, put a farmer or a small businessman, and all of that, require various things. I personally do not know of any legislation that can accomplish that. I think we're kidding ourselves if we think we can legislate the kind of decisionmaking that goes on in the process of trying to make monetary decisions, plus I'm also not much of a monetarist. You haven't been on the committee long, but you know my bias against deficits in the fiscal policy. And I'll just make one more comment.

In years when we had stable fiscal policy with reasonable expenditure rates and tax policies, nobody in this country knew the Fed existed. It was practically nonexistent. It wasn't in the press. The Chairman of the Federal Reserve Board was not called the second most powerful man in the country. And it was a relatively easy job.

The Fed has been forced into the forefront, in my opinion, by the irresponsible fiscal policy of the Congress. And I don't care who you make Chairman of the Fed or how long his term is, or what you do to him, as long as Congress sends him $200 billion deficits, it is one heck of a tough job and no legislation can change that.

Senator HUMPHREY. I agree with the chairman; he doesn't have to make a speech. [Laughter.]

Fiscal policy is grossly irresponsible, but that's not what we're discussing here today. In the confines, or within the constraints of the mess the Congress is making, the Federal Reserve has to operate, and I think it has been doing pretty poorly, even given those outside external problems.

CONGRESS IS SCAPEGOAT FOR THE FED

Mr. SAVIN. May I interrupt you, sir, to say that you have become their scapegoat. The fact is, also, there are countries which have financial stability, which have had for many years much larger budgetary deficits than we have, and indeed, the reason why we never heard about the Fed in the 1950's—I think that was the period to which you make reference——

The CHAIRMAN. And the 1960's.

Mr. SAVIN. And the early 1960's. We started hearing about them in the mid-1960's—is that we had a stable financial system which has bequeathed us with low-interest rates, nonexistent risk premiums, and there was no need. As I said, in those days, the Fed controlled the market by manipulating Fed funds. You knew what the specific content of that information was. You have to change the game.

Senator HUMPHREY. I think we have to remove the human element as much as possible. The question is, how to do that. The financial markets are going to be nervous, as long as the human element is largely controlling it, it seems to me.

Mr. SAVIN. With respect, Mr. Senator, you cannot remove the human element. The human element is the center of the circle.

Senator HUMPHREY. Not entirely, but of course we're dealing in human matters. The center of economic matters. It's all about human behavior. But in case of control of the money supply, it's entirely in the hands of a few human beings who are accountable to no one, and who have no accurate tools with which to work.

Mr. SAVIN. If you would say, sir, if you want to reduce their scope of government, I would agree with you, and all you'd have to do is lower the target and reduce the targets. Because if you have a target like 4 to 8 percent, and you say, "Well, if we look out next year, we'll probably reduce it in 1985," you're setting the stage for an inflation accident. We can call it an accident, of 4 percent more inflation. So if we don't know if the inflation is going to be 3, 8, or 10 percent, just in terms of self-protection, we'll discount 10.

Senator HUMPHREY. If somehow by legislation or otherwise you could persuade the Federal Reserve to focus on one specific growth figure, 4 percent or whatever it would be, have they the means of doing that for us with the imperfect tools they work with?

Dr. MEIGS. They have all the tools. They've had the tools. You gave them the power to extend reserve requirements to many, many more financial institutions. The tools are in their hands. The question is how they use them.

I would say ask them to set one monetary target. It really doesn't matter so much which one they set, just so there's one of them and they behave consistently thereafter and deliver what they say they're going to do.

Senator HUMPHREY. With all the lags, how could they hue that closely to it?

Dr. MEIGS. That's a good point. With all the lags, discretionary policy becomes very risky. They tend to act on the pressure of what's happening today as though they can affect everything today when we know what they do today may affect prices 2 years later.

If they were keeping that in mind they would be doing much less changing of policy from week to week and month to month. They wouldn't need to. The economy could adjust to that in expectations and the markets would become more stable, as I would argue for the Japanese example. It's a very good example. Other countries can do it and are doing it. So, why can't we do it?

Senator HUMPHREY. It beats me.

The CHAIRMAN. Because we have too much politics involved. That's why.

Gentlemen, thank you very much. We appreciate your testimony.

Next we would like to call Beryl Sprinkel, Under Secretary for Monetary Affairs of the U.S. Department of the Treasury.

I might just say for those who are interested, that is not a vote. It looks like one, but apparently we have a burned out light.

Mr. Secretary, if you'd like to proceed.

STATEMENT OF BERYL SPRINKEL, UNDER SECRETARY FOR MONETARY AFFAIRS, U.S. DEPARTMENT OF THE TREASURY

Mr. SPRINKEL. Thank you, Senator Garn and the other distinguished members of the committee. It's a pleasure to be here again to discuss with you the administration's view on monetary policy.

This administration came to office in 1981 with the conviction that inflation was a major obstacle to sustained economic prosperity and growth. An important part of President Reagan's economic program was, therefore, the recommendation that money growth be gradually decelerated to a noninflationary pace. This recommendation was based on the belief that a process of continued inflation can persist only when accommodated by excessive monetary expansion.

DELETERIOUS ECONOMIC EFFECTS OF INFLATION

By the late 1970's evidence of the deleterious economic effects of inflation was plentiful: Soaring interest rates, highly unstable financial markets, a precipitous decline in the international value of the dollar, speculative activity in commodity and real estate markets, a secularly rising unemployment rate and an erosion in the ability of U.S. industry to compete internationally.

The experience of a decade and a half of accelerating inflation had radically altered the behavior and expectations of the American public. In general, productive activity became less profitable than speculative activities or those designed to beat inflation. The uncertainty generated by rapid inflation made more difficult all types of economic decisionmaking—from the household decision of whether to buy a household appliance to a corporate decision of whether to expand capital spending.

After several short-lived attempts to restrain money growth and control inflation in the 1970's, by the end of the decade the problem of inflation was viewed by many—including many economists—as inherent and intractable. In contrast the past 3 years have brought progress on inflation that is truly remarkable. Since it reached its peak in mid-1980 we have seen the largest decline in CPI inflation in more than three decades. Even those of us who were totally committed in 1981 to the view that inflation could and would be brought under control, would not have dared to be so optimistic.

The experience of the past 3½ years has demonstrated inflation is not a disease that modern industrialized nations must accept. Inflation is not imposed upon us by uncontrollable forces. Sustained inflation is largely a monetary phenomenon. It can be controlled when monetary discipline is pursued. This is an important lesson for us all. For Government officials, Members of Congress, and voters in general. Only by learning from this experience can we permanently avoid repeating the policy mistakes of the past.

There is no reason why progress on inflation cannot be extended and inflation ultimately be brought to zero. Price stability does not mean there would be no changes in the prices of specific goods and services. Changes in individual prices are the essence of the market system at work. Despite inevitable—and desirable—changes in specific prices, some of us are old enough to remember when the general price level was basically stable from year to year. That was the period you were referring to a few moments ago, Senator Garn.

At the current time there is an enormous divergence of opinion among experts about the future course of inflation. At one extreme, some analysts foresee continued low rates of inflation, some have even suggested actual deflation. At the other extreme some analysts are predicting a significant reacceleration of inflation by the end of this year.

Some analysts believe that variables such as gold and other commodity prices are good leading indicators of inflation; so far, these variables have shown no convincing signals of rising future inflation. In addition, wage pressures appear to be moderate and productivity is rising. It has been argued that these developments should allay our concerns about inflation. The problem with this analysis is that these leading indicators of inflation have in the past sometimes given misleading signals—failing to foreshadow rising inflation or signaling a change in inflation that never materialized. Thus, such predictors of inflation, unfortunately, are not infallible.

The more pessimistic views of future inflation are usually based on the historical money-price relation as depicted in chart 1 of my testimony. Given the close relation in the past between money growth and inflation, money growth over the past 2 years raises serious concerns about the outlook for inflation. With the trend well above the rates of money growth associated with the acceleration of inflation in the mid-1970's, M1 growth, based on historical patterns, is giving off ominous signals for future inflation.

The regulatory changes instituted in late 1982 and early 1983 created uncertainty about the meaning of behavior of the monetary aggregates, especially in the shorter run. That uncertainty leads some analysts to doubt the forecasts of inflation based on money growth rates that encompass that period of time. Some analysts, include myself, incidentally.

The uncertainty about the effects of financial deregulation can be summarized by observing the behavior of velocity over this period of time. Velocity is the relationship between nominal GNP and the money supply; it is a summary description of the public's behavior with respect to total spending [GNP] and the money supply. Since the deregulatory changes in 1982–83 authorized transaction accounts that pay a market rate of interest, it is plausible that the public is now holding larger money balances for a given amount of spending. This would have the effect of suppressing velocity.

Chart 2 shows the historical behavior of velocity. As can be seen in the chart, it is not unusual for velocity to decline during a recession as increased uncertainty and lower interest rates typically induce the public to hold more cash balances. As money balances rise relative to spending, velocity falls.

DECLINE IN INFLATION CAUSES VELOCITY TO FALL

In addition, the decline in inflation and/or inflationary expectations would be expected to cause velocity to fall as the public is willing to hold larger cash balances. Thus the decline in velocity in 1981 and 1982 may not have been atypical. As can be seen in chart 2, however, velocity did not rebound in 1983 as the economy recovered as has been its historical pattern. This has led some analysts to conclude that the regulatory changes in 1982–83 have had a permanent effect on the behavior of velocity.

If so, it's reasonable to infer that the rapid money growth of 1982–83 will not have the inflationary impact that one would expect, based on historical experience; it is then logical to conclude that the outlook for inflation is less ominous. However, if one believes that despite financial innovation, the velocity relationship remains basically intact and that velocity will return to its historical level and growth path, then one must conclude that money growth over the past 2 years will result in a significant rise in inflation by the end of this year.

This is not the only source of uncertainty about future inflation, but it is an important one. That uncertainty is not without consequence. As President Reagan has stated on several occasions, the uncertainty about future inflation is a major factor in keeping interest rates high, relative to the current rate of inflation.

Despite the uncertainty about the behavior of M1 over the past 2 years, it does not appear that a serious reacceleration of inflation is on the horizon, provided that monetary policy is sound and noninflationary in the future. The bulge in money growth from mid-1982 to mid-1983 is behind us. If, nonetheless, the result is a surge in inflation, there is now nothing that can be done about it beyond adhering to a noninflationary monetary policy, designed to limit and contain the inflationary threat.

Beginning in mid-1983 the Federal Reserve Board decelerated money growth from the rapid rates of the preceding year. At that time the administration agreed completely that money growth had to be decelerated; our concern was that the deceleration be a gradual one, in order to avoid aborting the recovery or causing another economic downturn. The Federal Reserve did an excellent job of achieving that goal. In the past year, M1 growth has averaged a more modest 6.8 percent; during the first half of 1984, M1 growth has been extremely well behaved, remaining generally in the upper half of the Federal Reserve's target growth range.

In the last three or four quarters, velocity appears to be paralleling its historical trend, but along a lower path. While a few quarters' observations are not sufficient from which to confidently draw inferences, it is possible that this will turn out to be the ultimate result of recent deregulations: A one-time shift in the level of velocity, after which it will continue to follow a growth path parallel to the growth path projected from historical patterns. If so, the 1982–83 bulge in money growth can be viewed as an offset to the shift in velocity and no further adjustment of money growth targets is needed.

It is still too early to know whether or not regulatory changes have permanently altered the fundamental relationship between money growth and GNP. The policy dilemma is, of course, that by the time there is sufficient information on public behavior available to infer a statistically sound answer to the question, it will be too late to design and implement the appropriate policy actions.

In the interim, the most prudent course is to pursue a policy of money growth that subjects the economy neither to the danger of a monetary restriction nor to any additional risks of accelerating inflation. This implies a moderate rate of money growth that implicitly assumes velocity growth in the range of historical experience.

The target growth range for M1 tentatively set by the Federal Reserve for 1985 is prudent and consistent with this risk minimizing view of future velocity behavior. Chairman Volcker has indicated that in the future the FOMC will be giving roughly equal treatment to the various monetary aggregates in the implementation of monetary policy. This decision as well as the narrowing of the M1 target range and the 4 to 7 percent range itself, all imply that the Federal Reserve expects M1 velocity to behave more typically, based on historical experience. If this is the case, there is compelling historical evidence to recommend that M1 be the primary target of Federal Reserve policymaking. Among the various monetary aggregates, M1 historically has been the most reliable indicator of real economic activity in the short run and inflation in the long run.

The downward adjustment of the 1985 target ranges for M1 and M2 are, I believe, appropriate to our long-run goal of gradually decelerating money growth to a rate consistent with price stability.

PRICE STABILITY IS GOVERNMENT'S ECONOMIC FUNCTION

Thus, the administration agrees with and supports the target money growth ranges announced by Chairman Volcker last week. I take money growth targets very seriously; I hold this conviction for several reasons. First, I believe that providing basic price stability is among the most important economic functions of the Government and the function of a central bank. Whatever else Government may decide to do in the areas of redirecting resources or redistributing income, our efforts to promote economic expansion and stability are likely to be thwarted if basic price stability is not provided.

Whatever the problems that may arise with monetary control that can cause some to lose faith in the exercise, a monetary policy that focuses on reasonably close control of the monetary aggregates remains—like democracy—far superior to the alternatives. While the relationships between money and economic activity and money and inflation are by no means precise ones, they are more reliable than other relations, such as that between interest rates and economic activity, that are frequently suggested or employed as a guide to monetary policy.

Second, effective money growth targets convey to the public in general—and specifically to the financial markets, business, and investment planners—the intentions of the central bank with respect to future inflation. Preannounced money growth targets that are consistently met become a meaningful policy statement on which the business and investment communities can rely; predictable and prudent monetary trends minimize the uncertainty about future economic performance and inflation and provide a more stable economic and financial background in which savers and investors can more confidently plan and commit funds.

The value of money growth target—in imposing discipline and acting as a messenger of the Fed's intentions—is greatly diminished if targets are frequently not achieved or if they are changed at will. It is in this context of the overall usefulness of money growth targets that we urge the Federal Reserve to achieve the targets they have set. In addition, I urge that the Congress, as the branch of Government to which the Federal Reserve is ultimately responsible and accountable, join in that admonition.

While the Federal Reserve has been very successful in controlling money growth so far this year, the policymaking procedures of the Federal Reserve, in my view, contain inherent policy risks. The current policy approach of the Federal Reserve appears to be focused almost exclusively on targeting emerging real economic activity. The financial markets are completely aware of this. It is for this reason that announcements of economic statistics that imply continued economic expansion often cause interest rates to rise, as market participants expect the Fed to react by "tightening" monetary policy; in this way, "good" economic news becomes "bad" news, at least in the financial markets. It is particularly ironic that the Fed has sent this message to the financial markets during a period when money growth—the Fed's ultimate responsibility—has been quite well-behaved.

A policy of tailoring monetary growth to contemporaneous real economic developments implies significant potential dangers to the economy. Such a policy approach presumes that the Federal Reserve can foresee all the potential economic and political shocks to the economy, accurately predict their impact, and take offsetting policy actions in a timely fashion. That is a near-impossible task. A policy of targeting real economic growth subjects the economy to the risks of considerable destabilization as economic developments emerge that are unanticipated or inaccurately forecasted.

Since late 1982, the day-to-day operating procedures of the Federal Reserve have been designed to provide a prescribed degree of restraint or ease in money market conditions and bank reserve positions. This is functionally equivalent to a policy of targeting the Federal funds rate which was the Fed's operating procedure during the 1970's.

For periods of time, appropriate money growth may be generated by the Fed's practice of targeting money market conditions. This may occur either when market interest rates are well-behaved, or when there are no unforeseen movements in interest rates, or if the Fed is exceptionally good or even lucky at judging interest rate movements and their meaning for money growth. Under such a control procedure, money growth is not a variable that is deliberately controlled by policy actions, as it could be. Rather, money growth is a byproduct of the relation between market interest rates—which move frequently in response to a multitude of economic and political factors—and a Federal funds rate target that the Federal Reserve moves only infrequently and typically only with a delay.

If money growth is to be consistently well-controlled, the Federal Reserve, the administration, and the Congress must be willing to let interest rates move as market forces dictate. By allowing market forces to determine interest rates, the Federal Reserve could focus its day-to-day operations on controlling bank reserves or the monetary base, the growth of which ultimately determines money growth. The result would be a more stable and predictable pattern of monetary expansion.

The alternative—monetary instability—imposes important costs on the economy. Because of the close association between changes in money growth and real economic activity, volatile money growth induces similar fluctuations in the economy. In addition, each swing in money growth generates uncertainty about economic performance: on the upside, it renews fears about inflation; on the downside, it generates concerns about an economic downturn. That uncertainty adds a risk premium to the level of interest rates. More predictable and stable money growth would minimize the policy-induced fluctuations in the real economy, help reduce uncertainty, and consequently hasten the downward adjustment of inflation expectations and therefore interest rates.

In conclusion, institutional changes during late 1982 and early 1983 generated some atypical uncertainty about the meaning of money growth over that period. From a policymaking standpoint, those uncertainties appear to be behind us, even though the implications for future inflation may remain uncertain. The uncertainty about the inflation outlook is not inconsequential. Plainly stated, it causes interest rates to be higher than they otherwise would be.

I know of no reasonable or prudent way to quell the fears about future inflation other than adhering to a preannounced noninflationary path of money growth. Any alternative path of money growth implies serious risks to the economy. It is possible that inflation will rise in response to the accelerated growth during the last 2 years. There is little that can now be done about that, except pursuing a policy that limits any potential rise in inflation; attempts to abruptly reverse that bulge in money growth would certainly risk a monetary restriction of the economy. Alternatively, ignoring the potential for an increase in inflation would be equally irresponsible; we have come too far in reducing inflation, at too great a cost, to risk squandering that progress.

Our best chance of both protecting our gains toward price stability and avoiding any monetary restriction of the economy is for the Federal Reserve to provide moderate money growth. The target ranges announced last week by Chairman Volcker imply that this is the intended policy of the Federal Reserve. The administration supports this stated policy and strongly recommends that the Federal Reserve take the policy actions needed to assure these results. Thank you, Mr. Chairman.

[The complete statement follows:]

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BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
WASHINGTON, D.C.

Tuesday, July 31, 1984

Senator Garn, Senator Proxmire, distinguished Members of the Committee, it is a pleasure to be here again to discuss with you the Administration's views on monetary policy.

This Administration came to office in 1981 with the conviction that inflation was a major obstacle to sustained economic prosperity and growth. An important part of President Reagan's economic program was therefore the recommendation that money growth be gradually decelerated to a noninflationary pace. This recommendation was based on the belief that a process of continued inflation -- as distinct from an increase in the price of one good relative to others -- can persist only when accommodated by excessive monetary expansion.

By the late 1970's, evidence of the deleterious economic effects of inflation was plentiful: soaring interest rates, highly unstable financial markets, a precipitous decline in the international value of the dollar, speculative activity in commodity and real estate markets, a secularly rising unemployment rate, and an erosion in the ability of U.S. industry to compete internationally. The experience of a decade and a half of accelerating inflation had radically altered the behavior and expectations of the American public. As savers, we had learned that there was little point in abstaining from current consumption so that inflation could reduce the real purchasing power of accumulated funds. As workers, we learned the need to demand ever-rising wage rates, as inflation eroded the real value of income earned and bracket creep imposed higher and higher tax rates on incomes, that in many cases, were declining in real terms. As lenders, the uncertainty about rising inflation made us increasingly reluctant to commit funds on a longterm basis. Profits declined as producers were faced with rising costs, declining productivity, and intensified international competition. In general, productive activity became less profitable than speculative activities or those designed to "beat" inflation. The uncertainty generated by rapid inflation made more difficult all types of economic decision-making -- from the household decision of whether to buy a household appliance to a corporate decision of whether to expand capital spending.

After several short-lived attempts to restrain money growth and control inflation in the 1970's, by the end of the decade the problem of inflation was viewed by many -- including many economists -- as inherent and intractable. In contrast, the past three years have brought progress on inflation that is truly remarkable. Since it reached its peak in mid-1980, we have seen the largest decline in CPI inflation in more than three decades. Except for a fleeting period just after price controls were in effect, recent annual rates of inflation have not been experienced in the U.S. since the early 1960's. Even those of us who were totally committed in 1981 to the view that inflation could and would be brought under control, would not have dared to be so optimistic.

The experience of the past three and a half years has demonstrated inflation is not a disease that modern, industrialized nations must accept. Inflation is not imposed upon on us by uncontrollable forces. Sustained inflation is largely a monetary phenomenon; it can be controlled when monetary discipline is pursued. This is an important lesson for us all -- for government officials, Members of Congress, and voters in general. Only by learning from this experience can we permanently avoid repeating the policy mistakes of the past.

There is no reason why progress on inflation cannot be extended and inflation ultimately be brought to zero. Price stability does not mean there would be no changes in the prices of specific goods and services. Changes in individual prices are the essence of the market system at work; it is through increases or decreases in relative prices that shortages or excess supply conditions are resolved by the market. Attempts to suppress or subvert changes in relative prices prevent the market system from functioning as it should; invariably they only prolong the market imbalance, and ultimately distort the allocation of economic resources. Despite inevitable -- and desirable -- changes in specific prices, some of us are old enough to remember when the general price level was basically stable from year-to-year.

The Outlook for Inflation

At the current time there is an enormous divergence of opinion among experts about the future course of inflation. At one extreme, some analysts foresee continued low rates of inflation, some have even suggested actual deflation. At the other extreme, some analysts are predicting a significant reacceleration of inflation by the end of this year.

Some analysts believe that variables, such as gold and other commodity prices, are good leading indicators of inflation; so far, these variables have shown no convincing signals of rising future inflation. In addition, wage pressures appear to be moderate and productivity is rising. It has been argued that these developments should allay our concerns about inflation. The problem with this analysis is that these leading indicators of inflation have in the past sometimes given misleading signals -- failing to foreshadow rising inflation or signalling a change in inflation that never materialized. Thus, such predictors of inflation are not infallible.

The more pessimistic views of future inflation are usually based on the historical money-price relation as depicted in Chart 1. Historically, inflation has been closely related to the long-term, trend rate of M1 growth. The effect of money growth on inflation occurs with a lag, typically estimated to be 1-1/2 to 2 years. Chart 1 illustrates the annual rate of change in M1 and the GNP deflator, plotted so that money growth lags inflation by two years.

Given the close relation in the past between money growth and inflation, money growth over the past two years raises serious concerns about the outlook for inflation. For the two years ending in June, M1 growth averaged nearly 10%. Until very recently the two-year rate of money growth was higher than at any time in the post-World War II period. With the trend well above the rates of money growth associated with the acceleration of inflation in the 1970's, M1 growth, based on historical patterns, is giving off ominous signals for future inflation.

The regulatory changes instituted in late 1982 and early 1983 created uncertainty about the meaning of behavior of the monetary aggregates. That uncertainty leads some analysts to doubt the forecasts of inflation based on money growth rates that encompass that period of time.

The Behavior of Velocity

The uncertainty about the effects of financial deregulation can be summarized by observing the behavior of velocity over this period of time. Velocity is the relationship between nominal GNP and the money supply; it is a summary description of the public's behavior with respect to total spending (GNP) and the money supply. Since the deregulatory changes in 1982-83 authorized transactions accounts that pay a market rate of interest, it is plausible that the public is now holding larger money balances for a given amount of spending. This would have the effect of suppressing velocity.

Chart 2 shows the historical behavior of velocity; the solid line is the actual level of velocity and the dotted line is a trend line statistically estimated from the historical growth of velocity. As can be seen in the chart, it is not unusual for velocity to decline during a recession as increased uncertainty and lower interest rates typically induce the public to hold more cash balances; as money balances rise relative to spending, velocity falls. In addition, a decline in inflation and/or inflationary expectations would be expected to cause velocity to fall as the public is willing to hold larger cash balances. Thus the decline in velocity in 1981 and 1982 may not have been atypical; it may be attributable to the normal cyclical downturn, reinforced by the significant drop in inflation. As can be seen in Chart 2, however, velocity did not rebound in 1983 as the economy recovered, as has been its historical pattern. This has led some analysts to conclude that the regulatory changes in 1982-83 have had a permanent effect on the behavior of velocity.

If one believes that financial deregulation has caused either a one-time shift, or a permanent change, in the historical, behavioral relation between money growth and aggregate spending (velocity), it is reasonable to infer that the rapid money growth of 1982-83 will not have the inflationary impact that one would expect, based on historical experience; it is then logical to conclude that the outlook for inflation is less ominous. However, if one believes that despite financial innovation, the velocity relationship remains basically intact and that velocity will return to its historical level and growth path, then one must conclude that money growth over the past two years will result in a significant rise in inflation by the end of this year.

This is not the only source of uncertainty about future inflation, but it is an important one. That uncertainty is not without consequence. As President Reagan has stated on several occasions, the uncertainty about future inflation is a major factor in keeping interest rates high, relative to the current rate of inflation.

Implications for Monetary Policy

Despite the uncertainty about the behavior of M1 over the past two years, it does not appear that a serious reacceleration of inflation is on the horizon, provided that monetary policy is sound and noninflationary in the future. The bulge in money growth from mid-1982 to mid-1983 is behind us. If, nonetheless, the result _is_ a surge in inflation, there is now nothing that can be done about it beyond adhering to a noninflationary monetary policy designed to limit and contain the inflationary threat.

Beginning in mid-1983, the Federal Reserve decelerated money growth from the rapid rates of the preceding year; in the last two quarters of 1983, M1 growth averaged 7.3%. At that time the Administration agreed completely that money growth had to be decelerated; our concern was that the deceleration be a gradual one, in order to avoid aborting the recovery or causing another economic downturn. The Federal Reserve did an excellent job of achieving that goal. In the past year M1 growth has averaged a more modest 6.8%; during the first half of 1984, M1 growth has been extremely well-behaved, remaining generally in the upper half of the Federal Reserve's target growth range.

In the last three or four quarters, the behavior of velocity has become more typical, based on historical experience. As can be seen in Chart 2, velocity appears to be paralleling its historical trend, but along a lower path. While a few quarters' observations are not sufficient from which to confidently draw inferences, it is possible that this will turn out to be the ultimate result of recent deregulations: a one-time shift in the level of velocity, after which it will continue to follow a growth path parallel to the growth path projected from historical patterns. If so, the 1982/1983 bulge in money growth can be viewed as an offset to the shift in velocity and no further adjustment of money growth targets is needed. That judgment would also imply that there was no need for the Federal Reserve to reverse the surge in money growth from mid-1982 to mid-1983 by a severe restriction of money growth.

While the uncertainties about velocity behavior that have arisen recently are troublesome, uncertainty is inherent in the process of monetary policymaking, especially during a period of institutional change. It is the challenge of policymakers, in the face of uncertainty, to pursue policies that minimize the associated risks to economic performance. This can be demonstrated by considering more extreme judgments about the future behavior of velocity and the implications for the economy of basing policy actions on them.

It could be argued that the decline in velocity in 1981-83 was temporary, that velocity will recover as it has in the past, and return to its previous level and follow its historical growth path. This assumption implies the need to restrict money growth immediately in order to minimize or prevent a major resurgence of inflation. The risk of taking that policy action, however, is that if that judgment about velocity behavior turns out to be incorrect, a monetary restriction of the economy is likely. Thus the risk associated with this policy option is a monetary-induced slowdown or recession in economic activity.

At the other extreme, one could argue that velocity growth has been permanently affected and that it will in the future grow more slowly than its 3% historical trend. If so, the policy implication is to accelerate money growth in order to provide enough liquidity to support economic activity. The economic risk associated with this policy is that, if the judgement on velocity is incorrect and velocity grows at or near its historical growth rate, the acceleration of money growth will be inflationary.

Clearly neither of these options represents a risk-minimizing approach to monetary policy. It is still too early to know whether or not regulatory changes have permanently altered the fundamental relationship between money growth and GNP. The policy dilemma is, of course, that by the time there is sufficient information on public behavior available to infer a statistically sound answer to the question, it will be too late to design and implement the appropriate policy actions.

In the interim, the most prudent course is to pursue a policy of money growth that subjects the economy neither to the danger of a monetary restriction nor to any additional risk of accelerating inflation. This implies a moderate rate of money growth that implicitly assumes velocity growth in the range of historical experience.

The target growth range for M1 tentatively set by the Federal Reserve for 1985 is prudent and consistent with this risk-minimizing view of future velocity behavior. Chairman Volcker has indicated that in the future the FOMC will be giving roughly equal weight to the various monetary aggregates in the implementation of monetary policy. This decision, as well as the narrowing of the M1 target range and the 4-7% range itself, all imply that the Federal Reserve expects M1 velocity to behave more typically, based on historical experience. If this is the case, there is compelling historical evidence to recommend that M1 be the primary target of Federal Reserve policymaking. Among the various monetary aggregates, M1 has historically been the most reliable indicator of real economic activity in the short run and inflation in the long run.

The downward adjustments in the 1985 target ranges for M1 and M2 are, I believe, appropriate to our long-run goal of gradually decelerating money growth to a rate consistent with price stability. Thus, the Administration agrees with, and supports, the target money growth ranges announced by Chairman Volcker last week. We urge, as we have consistently in the past, that the Federal Reserve adopt the policy actions needed to achieve those target ranges.

The Importance of Money Growth Targets

I take money growth targets very seriously; I hold this conviction for several reasons. First, I believe that providing basic price stability is among the most important economic functions of the government and the function of a central bank. Whatever else government may decide to do in the areas of redirecting resources or redistributing income, our efforts to promote economic expansion and stability are likely to be thwarted if basic price stability is not provided. While price stability will not preclude economic problems and disruptions, the environment of economic growth, lower interest rates and expanding job opportunities that we all seek will not likely be sustained, in the absence of reasonable price stability.

Whatever the problems that may arise with monetary control that cause some to lose faith in the exercise, a monetary policy that focuses on reasonably close control of the monetary aggregates remains far superior, in my view, to the alternatives. While the relationships between money and economic activity and money and inflation are by no means precise ones, they are more reliable than other relations, such as that between interest rates and economic activity, that are frequently suggested or employed as a guide to monetary policy. Given the close historical relation between money growth and inflation, I believe that control of the monetary aggregates, prudently executed, provides the monetary discipline that is a prerequisite for long-run price stability.

Second, effective money growth targets convey to the public in general -- and specifically to the financial markets and business and investment planners -- the intentions of the central bank with respect to future inflation. Preannounced money growth targets that are consistently met become a meaningful policy statement on which the business and investment communities can rely; predictable and prudent monetary trends minimize the uncertainty about future economic performance and inflation and provide a more stable economic and financial background in which savers and investors can more confidently plan and commit funds.

The value of money growth targets -- in imposing discipline and acting as a messenger of the Fed's intentions -- is greatly diminished if targets are frequently not achieved or if they are changed at will. Monetary targeting can be an important device for promoting credibility and reducing uncertainty, but it cannot serve that function if we consistently excuse errors and redefine the targets. It is in this context of the overall usefulness of money growth targets that we urge the Federal Reserve to achieve the targets they have set. In addition, I urge that the Congress, as the branch of Government to which the Federal Reserve is ultimately responsible and accountable, join in that admonition.

Concerns for the Future

While the Federal Reserve has been very successful in controlling money growth so far this year, the policymaking procedures at the Federal Reserve, in my view, contain inherent policy risks. While their procedures may be successful for a period of time -- as they have been recently -- they are likely over time to needlessly expose the economy to policy-related risks.

The current policy approach of the Federal Reserve appears to be focused almost exclusively on targeting emerging real economic activity. The financial markets are completely aware of this. It is for this reason that announcements of economic statistics that imply continued economic expansion often cause interest rates to rise, as market participants expect the Fed to react by "tightening" monetary policy; in this way, "good" economic news becomes "bad" news. It is particularly ironic that the Fed has sent this message to the financial markets during a period when money growth -- the Fed's ultimate responsibility -- has been quite well-behaved.

A policy of tailoring monetary policy to contemporaneous real economic developments implies significant potential dangers to the economy. Such a policy approach presumes that the Federal Reserve can foresee all the potential economic and political shocks to the economy, accurately predict their impact, and take offsetting policy actions in a timely fashion. That is a near-impossible task because of the inaccuracy of economic forecasting, the lags and inaccuracies in reported contemporaneous economic data, and the length and variability of the lags in monetary policy. Thus, a policy of targeting real economic activity subjects the economy to the risks of considerable destabilization as economic developments emerge that are unanticipated or inaccurately forecasted.

Since late 1982, the day-to-day operating procedures of the Federal Reserve have been designed to provide a prescribed degree of "restraint" or "ease" in money market conditions and bank reserve positions. This is functionally equivalent to a policy of targeting the Federal funds rate, which was the Fed's operating procedure during the 1970's. Since the relationship between interest rates and money growth is not a dependable or predictable one (particularly as economic conditions vary), targeting the Federal funds rate generally yields very imprecise control of the monetary aggregates. This was recognized by the Federal Reserve when it abandoned that control procedure in 1979.

For periods of time, appropriate money growth may be generated by the Fed's practice of targeting money market conditions. This may occur either when market interest rates are well-behaved, or when there are no unforeseen movements in interest rates, or if the Fed is exceptionally good (or lucky) at judging interest rate movements and their meaning for money growth. Under such a control procedure, however, money growth is primarily determined by the movements of market interest rates relative to the Federal funds rate target. As a result, money growth is not a variable that is deliberately controlled by policy actions, as it could be. Rather, money growth is a by-product of the relation between market interest rates -- which move frequently in response to a multitude of economic and political factors -- and a Federal funds rate target that the Federal Reserve moves only infrequently and typically only with a delay.

If money growth is to be consistently well-controlled, the Federal Reserve (the Administration and the Congress) must be willing to let interest rates move as market forces dictate.

By allowing market forces to determine interest rates, the Federal Reserve could focus its day-to-day operations on controlling bank reserves or the monetary base, the growth of which ultimately determines money growth. The result would be a more stable and predictable path of monetary expansion.

The alternative -- monetary instability -- imposes an important costs on the economy. Because of the close association between changes in money growth and real economic activity, volatile money growth induces similar fluctuations in the economy. In addition, each swing in money growth generates uncertainty about economic performance: on the upside, it renews fears about inflation; on the downside, it generates concerns about an economic downturn. That uncertainty adds a risk premium to the level of interest rates. More predictable and stable money growth would minimize the policy-induced fluctuations in the real economy, help reduce uncertainty and consequently hasten the downward adjustment of inflationary expectations and therefore interest rates.

Conclusion

The institutional changes during late 1982 and early 1983 generated some atypical uncertainty about the meaning of money growth over that period. From a policymaking standpoint, those uncertainties appear to be behind us, even though the implications for future inflation remain uncertain. The uncertainty about the inflation outlook is not inconsequential; plainly stated, it causes interest rates to be higher than they otherwise would be.

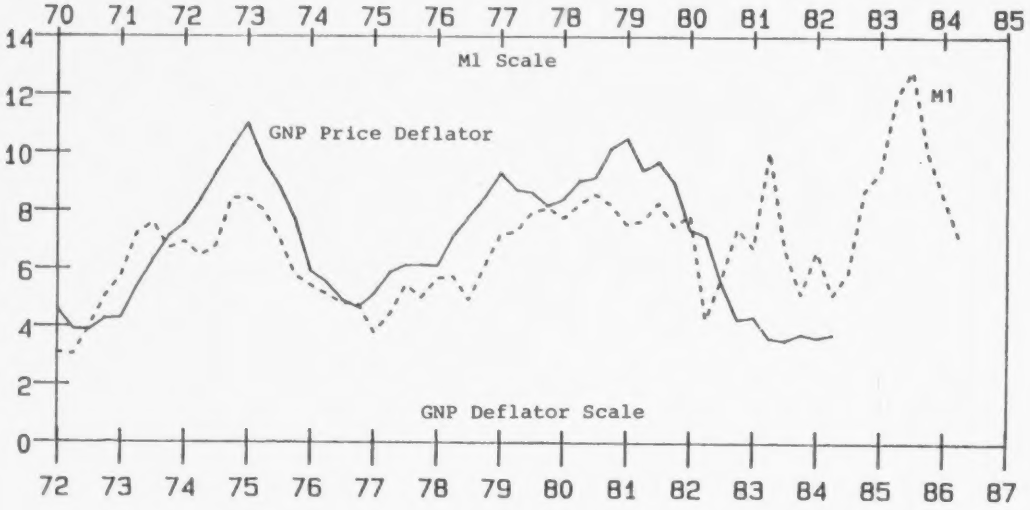
I know of no reasonable or prudent way to quell the fears about future inflation other than adhering to a preannounced, noninflationary path of money growth. Any alternative path of money growth implies serious risks to the economy. It is possible that inflation will rise in response to the accelerated money growth during the last two years. There is little that can now be done about that, except pursuing a policy that limits any potential rise in inflation; attempts to abruptly reverse that bulge in money growth would risk a monetary restriction of the economy. Alternatively, ignoring the potential for an increase in inflation would be equally irresponsible; we have come too far in reducing inflation, at too great a cost, to risk squandering that progress.

Our best chance of both protecting our gains toward price stability and avoiding any monetary restriction of the economy is for the Federal Reserve to provide moderate money growth. The target ranges announced last week by Chairman Volcker imply that this is the intended policy of the Federal Reserve. The Administration supports this stated policy and strongly recommends that the Federal Reserve take the policy actions needed to assure these results.

CHART 1

MONEY LEADS INFLATION BY TWO YEARS

Growth Rates in GNP Price Deflator and Money Supply*

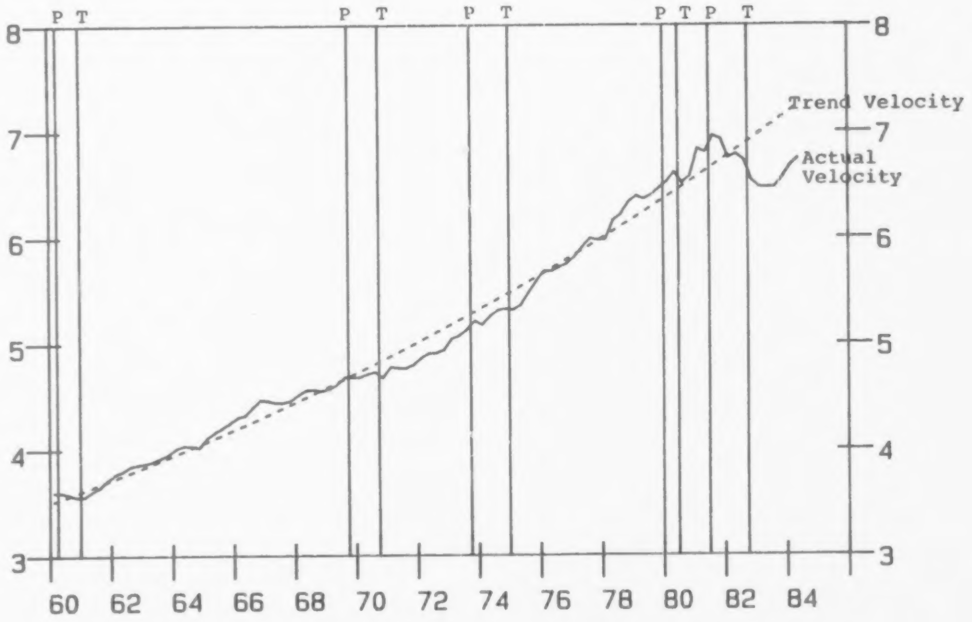


*Quarterly figures. Growth measured from one year earlier.

Latest date plotted: Second quarter, 1984.

CHART 2

VELOCITY AND TREND VELOCITY, 1960Q1 - 1984Q2*
(velocity=line, trend velocity=dot)



*VELOCITY IS M1-VELOCITY. TREND VELOCITY IS BASED ON A TIME TREND ESTIMATED OVER 1960Q2-1981Q3 AND FORECASTED OUTSIDE THIS INTERVAL.

The **Chairman**. Senator Hecht, do you have any questions?

[No response.]

The **Chairman**. I have a few questions I'd like to ask you.

May I gently chide both you and Dr. Poole for not having your statements in in advance so that we could have an opportunity to review them. The committee rules request the statements to be in the day before.

When you testified before the committee in February you stated, and I quote:

> The slowdown in money growth during the last half of 1983 subjects the real economy to the risk of an unacceptable slowdown or downturn in the first half of 1984. That threat continues and grows the longer the money growth is constrained to a slow rate.

Now, your prediction appears to be wrong in light of the continued much more rapid expansion than was anticipated and we've also maintained price stability at least so far.

Would you now say the Fed was precisely on the right course, that we should stick to that course or were they wrong last fall?

Mr. **Sprinkel**. First, the interpretation of what that sentence might mean. The important part of the statement was that continued low, decelerated money growth could mean problems. Fortunately it did not continue. As I pointed out in my testimony, money growth has been 6.8 percent over the past year. Since the early part of this year it has been a little higher than that, 7 to 8 percent.

There was not continued deceleration of money growth, although there was very significant deceleration in the last half of 1983. We never in the administration, to my knowledge, predicted a recession this year. We merely pointed out that if continued significant deceleration of money growth had occurred, it would have been a very good possibility. Fortunately, it did not occur.

CHANGE IN THE DEFINITION OF M1

In looking back at what happened, during the period of deregulation, which of course we supported, created some unusual noise in the numbers. And it seems to me increasingly probable that the major noise that occurred was in one sense a change in the definition of M1.

We now include in M1, as you know, super-NOW accounts and certain other interest-bearing instruments, which were previously closer to M2. If you try to extract from that effect, then you do not see the massive deceleration that occurred in late 1983 and very early 1984, because the growth rate did not rise in the first place to the same degree.

So it seems very probable to me that we are on the right track. Gradual deceleration of money growth over the next 3 years will get us to our goal of zero inflation, without the necessity of bringing on another very costly slowdown in economic activity.

The **Chairman**. Would you agree with the previous witnesses that we try to take in too many indicators and we ought to have one?

Mr. **Sprinkel**. I would personally much prefer concentration on one. During periods of institutional change, there can be considerable uncertainty about the meaning of the behavior of the monetary aggregates. But if you look at the long-term history of M1 versus the other series, it's been more closely related, both to inflation and in the longer run, 1½ to 2 years later, and also in the shorter run, 6 to 9 months, I'd add this to the real economic activity.

I wouldn't ignore the others, but in terms of targeting, my own judgment is that M1 deserves the greater weight.

The **CHAIRMAN**. Six months ago you attributed the failure of interest rates to fall, to the fact that inflationary expectations take a long time to break and the volatility of a money supply growth, I should add an uncertainty premium and a nominal interest rate, we had another 6 months not only of low inflation but also a relatively stable monetary growth.

How much longer do we have to wait for interest rates to fall?

Mr. **SPRINKEL**. I wish I knew that, Senator Garn, and I don't. I still believe that is the major force accounting for the relatively high market rates that presently exist.

Now, I have noted, but I'm not certain it's important, that in the last few weeks, there has been much more discussion about disinflation. Interest rates are off their highs by 50 basis points or so, depending upon the portion of the market.

If we can continue to convey, with the help of the Congress, the view that we're going to get the deficit down, and that the Fed is going to continue to gradually decelerate money over time, I think that will help.

But it won't happen quickly. It didn't happen in the late 1970's. You may remember when we were going the other way, as inflation accelerated, we observed negative real rates, if you compute real rates as actual inflation subtracted from nominal interest rates. But it took some time before the markets really believed that we were heading for a significantly higher inflation rate.

Eventually it got the message. It's taking a while this time and the sooner the better. There are certain people that are benefiting from the high interest rates—savers. But most of the investors are being hurt.

Rising interest rates have serious implications for international debt problems and we want to recommit ourselves to going toward a zero inflation target. We're not there yet, but we're two-thirds of the way there and we want to go the other third. And with the help of the Congress and the Federal Reserve we will.

The **CHAIRMAN**. I think the major factor there that you mentioned is the deficit. I realize these are monetary policy hearings that we conduct every 6 months but we always seem, at least in my opinion, to gloss over the impact of the deficits.

REAL INTEREST RATES STILL HIGH

I get around a great deal around this country and I don't hear nearly as much discussion about the M's, the rate of growth of the M's, as I do about deficits. And in my own opinion I think that's why the predictions of everybody, not just you, most everyone 6 months past, another 6 months past, and everybody complains that real interest rates are still too high.

I don't think it's nearly as much what the Fed is going to do as the fact that Congress has not yet come to grips with the deficit. If you're in the money lending business and you have been lied to by Congress after Congress after Congress for decades about what they're going to do about fiscal policy and it never comes true, after 30 years maybe you finally decide, hey, they don't really mean it.

They're really not going to do anything about it. And we had them. That downpayment isn't enough to qualify for a home loan mortgage that we put on the deficit. It's almost a shame to call it a downpayment. It's a token at best. An election year token.

So, as I say I'm not a trained economist. But for 10 years I've sat here at this bench listening to trained economists and most of them have been wrong. And I understand that. It's very difficult to predict but, on the other hand, it just becomes more and more evident to me all the time that deficits are the major culprit in the psychological impact on the markets.

They say, hey, these guys aren't going to do anything about this. All we see is a return to inflation. All we see is ever increasing deficits. All we see is more Treasury borrowings to finance that debt.

So why should we loan money at a reasonable rate. Why should we get trapped again. I really think if we would do something significant about the deficit, I think you would see a remarkable reduction in interest rates in a very short period of time.

In fact, I would go so far to say as if the Congress would make a significant debt reduction effort this year I think you'd see single digit prime within 6 months.

Just knowing that we've made structural changes within the budget that will guarantee the trend lines leveling of deficits and then starting down. Even if it took us decades to reach a balanced budget. I think that psychological impact on interest rates should be very dramatic.

But I can't believe Congress—I don't know why the market should, we talk a lot. There are no liberals in Congress this year. They're all born-again converts to the balanced budget regardless of what their past performance has been.

They're all born-again converts to the balanced budget except when it comes time to vote. I think that's a factor we don't talk enough about. Maybe again, that's what I've said before but to the previous two gentlemen.

Witnesses are intimidated by sitting up here in Congress. They don't want to say how fiscally irresponsible we are to our faces. Maybe that's the way we talk about others' monetary policies in these hearings rather than the truth of the matter, because we don't want to.

Some day I would like to come back after I'm fortunate and have the good enough sense to retire from this body to come back as a witness.

Mr. Sprinkel. Senator Garn, as I've said, there are weaknesses in our institutions, but the alternatives seems to be worse. I fully share your view that the deficit be brought down over time. I do not look upon monetary and fiscal policy as substitutes. I look upon them as complements. We need sensible monetary policies, and we need sensible fiscal policies. It's very difficult in our institutional arrangements to get the discipline on spending that is really necessary, in order to make major changes toward getting the deficit down.

BALANCED BUDGET AMENDMENT

President Reagan has argued, and I fully support his view that, if he can get some additional tools with the help of the Congress, he will go about reducing the deficit primarily by reducing spending. I am talking here about taking advantage of the sense that we have, that everybody wants to balance the budget. Let's get a balanced budget amendment. That would force competing interests for spending at the Federal level to compete against each other, instead of competing against a box and merely increasing the deficit more and more, which Secretary Regan and I have to finance.

Second, I know there is great sensitivity in the Congress about the line-item veto. But again this would be a very helpful device, in terms of getting more discipline into the spending proclivities.

The **Chairman**. Besides the balanced budget amendment and a line-item veto, which I would support, and did on the floor of the Senate, a constitutional amendment limiting a President to one 6-year term, Senators to two 6-year terms, and Representatives to three 4-year terms, you might see some statesmanship again, and they might not try to make a living until they're being here until they're 95 years old. Maybe that would be the only way to get that kind of amendment passed is to make it effective in the year 2050, when nobody currently here would think that they would still be around.

There are some who I think expect to be here. [Laughter.]

Last February you echoed what I take it to be a fairly traditional monetarist sentiment in stating that "Money growth affects the rate of inflation over a lag of 1½ to 2 years." Now, 1½ to 2 years ago from today, we were experiencing very rapid money supply growth. Shouldn't we have been experiencing a burst of inflation then right now?

Mr. **Sprinkel**. It's very important to follow numbers carefully, but it's also important to investigate what those numbers really are.

The **Chairman**. Let me say in your defense that the other witnesses this morning talked about the same thing.

Mr. **Sprinkel**. The so-called monetarists and those expecting a rapid reacceleration of inflation are walking to a different drumbeat than I am, and I think they're walking to an incorrect one. The major bulge that occurred in the M1 series was due to the deregulation which we all supported, which led to a massive surge in certain interest-bearing instruments, primarily super-NOW accounts. That surge has tapered off. Therefore, I think we should look upon that as a temporary aberration in the series. Most of the liability side of banks' balance sheets, that is monetary components, are now deregulated. There are no more big shocks coming. Hence, I would argue that the probability is that the money numbers are more believable now than they were a couple of years ago.

So, no, I do not believe that we are on the verge of a major resurgence of inflation. It is possible we could be, but if you adjust the money numbers, they do not suggest it. And if you look at sensitive commodity prices that sometimes help you in analyzing whether inflation is about to accelerate, I do not see any real pressure on the upside. So my best sense is that we're not looking forward to sharp acceleration, provided we continue to hew to moderate growth in money.

The CHAIRMAN. I don't anticipate renewed inflation this year or early next year.

Getting back to the psychological value of what we do or do not do here, I personally feel that with all the talk about the downpayment this year, and then next year we're really going to do something about it after the election, that has been so widely spread, that we've set ourselves up, and I'm glad we have.

If we don't follow through on that promise, I don't think we can have, regardless of what Paul Volcker, or the Fed, or the Open Market Committee does with the money supply next year, if Congress does not fulfill that promise that they have laid out and continue to do and will do every day until November 6, if that's the election day, then I think the only consequence can be renewed inflation and higher interest rates. I don't think there's another possibility. The markets will respond and say, "Hey, we believed you. We got the downpayment. We expect you to do this." And all the other reasons we hear.

Well, that's been discounted in the bond market. We already anticipated that. But we haven't anticipated yet the failure of Congress to do something next year.

So I can't emphasize enough that this is something Congress, ought to be laid totally at our doorstep. We set it up, no one else. We've said we're going to do that next year. So we'd better. Then I think you could have a burst of inflation. And those who vote that way ought to be then punished in the 1986 elections for not voting the way they talked before the 1984 elections.

And I'm obviously trying to set it up more to put pressure on my colleagues to vote like they talk.

Mr. SPRINKEL. I'm very supportive of your efforts. We appreciate it, and we will do our part to try to keep the budget numbers that we submit to you under control. And we hope the Federal Reserve will do its part. Given the stable, moderate growth of money, I gather we could solve this problem.

The CHAIRMAN. I would agree with that. The point I was making earlier about the Fed not having a difficult time with fiscal policy, their job, and I'm certainly not always pleased with the job they've done, I've been very critical of some of the mechanics of how they have handled the money supply, not their overall objectives but the mechanics of going through it, but their job has been made incredibly difficult, when you've had such an irresponsible fiscal policy. My point is, the Fed would become much less visible, if we had a stable fiscal policy, because then it would be much easier to be a member of the Federal Open Market Committee. You could have much more stable monetary policy and everybody would be congratulating you for the good job you're doing.

So I don't disagree that it takes two. One side of the equation has been trying, the Fed, however critical we may be of them. The fiscal side has not been trying. So I think we've got to get our act together first. I think in this case it's pretty easy to see which comes first, the horse or the cart. I think we've had it backwards.

We'll look forward to seeing you again in 6 months, and we'll see how your predictions are for that period of time.

Mr. SPRINKEL. Thank you, Senator.

The CHAIRMAN. The committee is adjourned.

[Whereupon, at 12 noon, the hearing was adjourned.]

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